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FOREWORD

This symposium on War Contract Renegotiation is one of a series of three dealing with problems arising out of the impact of the war upon war contracts and profits therefrom. The first, recently published, is on the subject of Excess Profits Taxation; following the present one there will shortly be published a symposium on the subject of War Contract Termination.

Little argument is needed to establish the contemporariness of this particular issue of LAW AND CONTEMPORARY PROBLEMS. As these words are being written (late December, 1943), there has come from the press and radio a flood of commentary upon the renegotiation provisions contained in the Revenue Bill of 1943, particularly in the form in which the Bill was approved by the Senate Finance Committee.

Although this symposium was planned long before the introduction of the pending Revenue Bill of 1943, it has been decided not to postpone publication until final clarification. Even if the Bill were to pass in the form which it now presents as the result of the Senate Finance Committee's recommendations (which is by no means assured), this symposium would not be invalidated. Interest would continue in the written record of the background of renegotiation, as set forth in the first three articles. These articles deal with profit limitation attempts in the past (Hensel and Lt. McClung), the development of renegotiation, especially as an adjunct to procurement (Marbury and Major Bowie), and the general picture of pricing in war contracts (Lloyd). Incidentally, Lloyd's article invites re-examination of statements frequently made that careful procurement, especially if coupled with an excess profits tax, makes renegotiation unnecessary.

More important, much of the standards, practices, machinery and procedures that are revealed in the pages that follow would continue relevant. So long as renegotiation remains at all, as it does even under the Senate Finance Committee proposals, this administrative experience will be utilized and presumably applied with only such changes as are necessitated by the congressional amendments. The articles on standards and practices (Blough), administrative machinery and procedures (Colonel Boyd), and the tie-up with income taxation (Colonel Watts), fall into this group.

The portion of this symposium that would be most affected by the pending legislation is the article on coverage and exemptions by W. John Kenney. In fact, if the pending legislation were adopted in its present form, attention would prob-

ably be focussed on the scope of the Act more than on any other single feature. A satisfactory survey in detail of all the ramifications of the changed emphasis could not be made until several months after the adoption of the Bill, which is another reason for not postponing publication of this symposium. Meanwhile, an over-all discussion of the effect of the pending legislation is to be found in the concluding article of this symposium by Jules Abels on the 1943 Revenue Bill renegotiation proposals. Most of the changes in the proposed legislation are discussed systematically in that article rather than being separately treated as specific points occur elsewhere in the symposium. That article should be kept in mind in reading the other articles.

Articles on constitutionality (Professor Collier), and surveying the *pros* and *cons* of renegotiation (H. L. Wilson), round out the discussion.

This symposium does not purport to be a manual of renegotiation procedure. Exigencies of space make it inadvisable to include, for example, the full text of the War Department's Procurement Regulation No. 12, relative to renegotiation and price adjustment, the Ordnance Procurement Instructions, Part 12, the Joint Statement by the War, Navy, and Treasury Departments, and the Maritime Commission, relative to purposes, principles, policies and interpretations under the Renegotiation Act, and the various forms of assignment notices, letters and reports. Many of these are available from the Technical Information Branch, War Department Price Adjustment Board; others from various published services. There is a possibility that by the time this reaches the reader the new Joint Renegotiation Manual for renegotiation may be available to the public.

Pardon is begged for introducing a perhaps unnecessary note of caution against false hopes. Renegotiation purports to turn back to the Government, whether by siphoning off some of the profits for a particular period or by changing price terms of contracts, the "excessive" profits which otherwise would have been made on the government business in question. What are "excessive profits" is, of course, the most crucial question in renegotiation. No short, easy answer to that question is to be found in the pages that follow.

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PROFIT LIMITATION CONTROLS PRIOR TO THE PRESENT WAR

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In the *Bethlehem Steel Corporation*[1] case, Mr. Justice Black concluded the majority opinion of the Supreme Court with the following remarks:

"The problem of war profits is not new. In this country, every war we have engaged in has provided opportunities for profiteering and they have been too often scandalously seized. * * * To meet this recurrent evil, Congress has at times taken various measures. It has authorized price fixing. It has placed a fixed limit on profits, or has recaptured high profits through taxation. It has expressly reserved for the Government the right to cancel contracts after they have been made. Pursuant to Congressional authority, the Government has requisitioned existing production facilities or itself built and operated new ones to provide needed war materials. It may be that one or some or all of these measures should be utilized more comprehensively, or that still other measures must be devised. But if the Executive is in need of additional laws by which to protect the nation against war profiteering, the Constitution has given to Congress, not to this Court, the power to make them."

In general, definitive Governmental steps to effectuate a limitation of munitions profits have awaited the outbreak of a war.[2] No real effort was made in this country to impose systematic restrictions upon the profits of manufacturers of munitions prior to World War I. Furthermore, with the exception of several statutes limiting the price to be paid for armor plate, enacted in the Spanish-American War, all efforts to limit war profits prior to 1917 were initiated by the Executive arm of the Government. Congress evidenced considerable interest in the prices of war matériel during the previous wars, but in the main its activities were limited to investigation and criticism. In the years between World War I and the present war, the Congress devoted a great deal of attention to the matter of limiting war profits and made a number of reports on the previous experience with war profit limitation attempts which could today be studied with a great deal of profit. Nothing definitive, however, was enacted prior to this war.

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[1] See United States v. Bethlehem Steel Corp., 315 U. S. 289, 309 (1942).

[2] See ENCYC. SOC. SCIENCES, articles on *Profiteering* (1934), *Munitions Industry* (1933).

I. OBJECTIVES OF WAR PROFITS LIMITATIONS

Before discussing the various attempts to control war profits undertaken by the Federal Government prior to this war, it is necessary to try to eliminate some of the confusion necessarily inherent in the objectives of *price* limitations and the objectives of *profit* limitations. *Price* limitations may involve profit limitations but not necessarily. *Price* limitations are devoted to an economic problem, i.e., keeping war costs at a minimum. Wartime profit limitations on munitions are directed primarily at a morale problem, i.e., the prevention of a slump in the nation's morale resulting from knowledge that war producers are enjoying what are generally and publicly recognized as excessive profits. We are all agreed that no one should become "rich" through a war.

"Morale" is an intangible substance, impossible to define precisely. Morale is largely a psychological matter. The armed forces and the taxpayers demand a forthright attempt on the part of the Government to prevent a few of the war contractors from making the war an unconsciously profitable venture for themselves. The difficulties in translating such desires into practical results lie in the fact that we are still relying on the profit motive as the main incentive for speedy, efficient and economical production. In an economy as complex as our national economy, and so long as the profit system remains the primary incentive to produce in time of war, there can be no absolute equalization of the burdens, or profits, of war. Our problem is, therefore, to maintain production with profit and morale without undue profit.

The imposition of price controls is almost always dictated by desires to minimize profits and yet too often fails to give full weight to the necessity of keeping the costs to the Government of procurement of munitions as low as possible in the light of all pertinent circumstances. This control of cost to the Government is logically a vastly more important matter than the limitation of profits to the contractor, yet that is not realized by the general public. Furthermore, price controls, dealing with all the elements of price, are difficult to establish. The Government in wartime must attempt in every way possible to encourage increased efficiency in production and the ensuing reduction in contractors' costs. Prices of munitions to the Government in wartime must be based, or perhaps, measured, ultimately upon cost of production. There is no other standard in wartime upon which to compute such prices. Producers should, of course, receive different *rates* of profits based upon the efficiency and skill with which they can reduce their costs of production. War procurement must also take into account many factors which affect cost—labor supply problems, maintenance of small businessmen, encouragement of inventions, and the like. Furthermore, the Government must acquire war supplies and weapons regardless of the cost to it or to the contractor.

The cost-plus form of contract has often been advanced as the only method of accurately determining the profits to the contractor; yet the cost-plus-a-percentage-

of-cost contract induces waste and high costs and the cost-plus-a-detemined-dollar-fee contract contains no incentives for reduced costs and minimizes the spur of the profit incentive. Profits should, theoretically, be a reward for performance and should be judged and compared in terms of relative performance.

In addition, profits are a relatively minor factor in the overall cost to the Government when munitions are being procured on the vast scale required for this war; a one per cent difference in profits would probably create more millionaires today than were created in the whole of World War I and have a small effect on our national economy. Government limitation of profits is also a major factor in minimizing inflation.

We are, indeed, faced with a dilemma and it is in this light that our previous failures to solve the problem should be judged.

II. ATTEMPTS PRIOR TO WORLD WAR I

In the early wars of this nation, contractors sold war materials to the Government at exorbitant prices. There are numerous public references during the Revolution to the excessive profits of suppliers and contractors, particularly in foodstuffs.[3]

The Continental Congress did evidence considerable interest in the costs of articles of war. For instance, the Naval Committee in 1775 recommended the construction of thirteen frigates as the backbone of the new American Navy and recommended further that the cost of these vessels, with two complete sets of sails, should not exceed $66,666 on the average. On December 13, 1775, the Continental Congress appointed a committee, "with full powers to carry the above report into execution," and thus indicated its intent that the vessels authorized should be acquired within the cost estimated by the Naval Committee.[4] As a matter of fact, the Revolution did summon into activity an immense range of legislative power over prices and profits. Most of this power was exercised by the states, for the Continental Congress constituted a government with limited authority over the loosely-knit federation of states. It was the legislation by the states during the Revolution, however, which laid the broad foundation for the legislative power of the national government in time of war. Thus we find that the Continental Congress on November 22, 1777 recommended to certain of the state legislatures that they appoint "commissioners to regulate and ascertain the price of labour, manufactures, internal produce" and so forth. A month later the same body recommended "to the respective legislatures of the United States, forthwith to enact laws, appointing suitable persons to seize and take, for the use of the Continental Army of the said States, all woolen cloths, blankets, linens, shoes," and so on. In response to these resolutions, the state legislature did enact many laws fixing prices of labor and commodities, sometimes in the greatest detail.[4a] Typical of the attempts to control prices during

[3] *Hearings before the Committee on Military Affairs on H. R. 3 and H. R. 5293*, 74th Cong., 1st Sess. (1935) 590-598.

[4] JOURNALS OF CONGRESS 1774-1776 (Folwell ed. 1800) 272.

[4a] J. REUBEN CLARK, EMERGENCY LEGISLATION PASSED PRIOR TO DECEMBER 1917 (1918) 211, 212, 214-217, 420, 466, 535, 595, etc.

the Revolution was the law enacted by the State of New York in 1780 under which the profits of manufacturers, wages of mechanics and laborers, and prices of a long list of commodities were fixed at a figure "not to exceed twenty fold of the prices paid in 1774." The latter date was chosen as reflecting normal conditions, and the twentyfold as measuring the debasement of the continental currency. This statute represented an effort to check inflation after it had occurred.[5]

Both the Army and the Navy were rather restricted by the parsimony of the Congress in the years between the Revolution and the Civil War. No real attempts were made to prevent profiteering in war supplies during this period, in part because so few supplies were being purchased.

The Civil War saw a vast increase in the purchases of war matériel, with large-scale profiteering evident in the procurement of both the Army and the Navy. In the War Department, Secretary Stanton, after his appointment in 1862, made strenuous efforts to effect an improvement in the methods of Army purchasing. He established a commission to audit and adjust claims under contracts with the War Department and this commission in 1862 and thereafter was successful in eliminating many excessive and fraudulent claims.[6] The most publicized war contracts were those let by General Frémont, Commander of the Western Department, in the early part of the war.[7] The Secretary of War appointed the Holt-Davis Commission to reconsider all of the contracts let under General Frémont's direction, and this Commission was instrumental in negotiating settlements at reduced prices with a large number of the contractors.[8]

Secretary of the Navy Gideon Welles met with similar difficulties in acquiring new vessels and supplies for the Navy during the Civil War. After unsatisfactory experiences with commission agents in the early months of the war, Welles in 1861 appointed his brother-in-law, George D. Morgan, as the agent to make all purchases of vessels for the Navy.[9] Morgan did an efficient job of buying vessels at much lower prices than the Navy had theretofore paid. The Secretary of the Navy was severely criticized for appointing a relative as the sole agent for the purchase of vessels, and the House Select Committee on Government Contracts submitted a resolution calling for the disapprobation by the House of Representatives of the practice. Even the Congress, however, was forced to admit that substantial savings had been effected by Morgan's purchases.[10]

[5] H. R. REP. No. 808, 75th Cong., 1st Sess. (1937) 3 (Report of the House Military Affairs Committee on H. R. 6704).

[6] REP. SEC'Y WAR (1862); cf. also CARL SANDBURG, ABRAHAM LINCOLN, THE WAR YEARS (1939), Vol. I, 423, 440.

[7] Frémont's purchases resulted in a number of actions in the courts. Reeside v. United States, 2 Ct. Cl. 1 (1866), aff'd by a decision of the Supreme Court reported at 7 Ct. Cl. 82 (1868), gives a detailed picture of how Frémont operated in purchasing Army supplies. See also United States v. Morgan, 154 U. S. 565 (1869); United States v. Burton, 154 U. S. 566 (1869); United States v. Adams, 74 U. S. 463 (1868), reversing 2 Ct. Cl. 70 (1866); United States v. Mowry, 154 U. S. 564 (1869), reversing 2 Ct. Cl. 68 (1866).

[8] United States v. Adams, 74 U. S. 463 (1868).

[9] REP. SEC'Y NAVY (1861).

[10] See discussion on the report of the House Select Committee on Government Contracts, 131 CONG.

All of the efforts at limitation of profits on Government contracts during the Civil War were undertaken by the Executive Departments, with, it is true, considerable prodding by the Congress. Many of the excesses in the prices paid for war munitions were the result of outright fraud upon the Government, and bribery of Government officials was by no means uncommon. Congress did enact various criminal statutes to prohibit certain of the fraudulent practices in connection with Government contracts.[11]

While the Civil War gave impetus for a time to large scale production of war munitions, no permanent munitions industry grew up in this nation, because the Army and Navy ordered almost nothing for some years after the war. It was not until the Government began to build the new Navy in the early eighties that important contracts for munitions were let to large manufacturers.[12]

In the development of plants in this country for the manufacture of heavy armor for the ships of the fleet, the Navy had paid prices for armor ranging between $574 and $671 per ton. Feeling that such prices were unreasonable, the Congress enacted a statute approved March 3, 1897, limiting the average price to be paid by the Navy for armor to $300 per ton. Several months thereafter another statute was passed authorizing the Secretary of the Navy, if he could not procure armor at $300 per ton, to establish a public armor factory and to appoint a naval board to advise him on the subject.[13] The armament manufacturers refused to manufacture armor at this price, and with the outbreak of the Spanish-American War in 1898, Congress increased the authorized price to $400.[14] Contracts were let on this basis, but Congress by the Act of March 3, 1899, again limited the price to $300 per ton.[15] Again the manufacturers refused to submit any bids except at prices per ton considerably in excess of this amount.[16] Finally, by the Naval Appropriation Act, 1901, the Congress authorized the Secretary of the Navy to procure by contract armor "at a price which in his judgment is reasonable and equitable"; if the Secretary could not make satisfactory contracts for armor, he was authorized to erect a factory to produce heavy armor, and $4,000,000 was appropriated for the purpose.[17] The armor plant was never erected by the Navy.

GLOBE, Vol. 32, Pt. 4, 37th Cong., 2d Sess., Appendix, April 28, 1862, 124-130; CARL SANDBURG, ABRAHAM LINCOLN, THE WAR YEARS (1939), Vol. I, 426. For further consideration of both Army and Navy contracts, cf. the testimony and reports of the Committee on Government Contracts, 37th Cong. (1862), Vols. 1 and 2; H. R. EXEC. DOC. No. 65, 39th Cong., 2d Sess. (1866-67).

[11] *Cf.* Act of July 16, 1862, 12 STAT. 577 (1862), with slight modification now 18 U. S. C. 1940 ed., §§199, 202; Act of July 17, 1862, 12 STAT. 594, 596 (1862).

[12] HAROLD and MARGARET SPROUT, THE RISE OF AMERICAN NAVAL POWER (1939) 165 *et seq.*; 11 ENCYC. SOC. SCIENCES (1934) 128 (article, *Munitions Industry*).

[13] C. O. PAULLIN, A HALF CENTURY OF NAVAL ADMINISTRATION IN AMERICA, 1861-1911, 40 UNITED STATES NAVAL INSTITUTE PROCEEDINGS (1914) 1059, 1061; Act of March 3, 1897, 29 STAT. 648, 665; Act of July 19, 1897, 30 STAT. 105, 123; JOHN D. LONG (Secretary of the Navy, 1897-1902), THE NEW AMERICAN NAVY (1903), Vol. I, 46 *et seq.*

[14] Act of May 4, 1898, 30 STAT. 369, 390.

[15] Act of March 3, 1899, 30 STAT. 1015, 1045.

[16] LONG, *op. cit., supra* note 13 at Vol. I, page 50.

[17] Act of June 7, 1900, 31 STAT. 684, 707; H. R. Doc. No. 95, 55th Cong., 2d Sess.; 31 CONG. REC. 934 (1898), 32 CONG. REC. 2190-2191 (1899); Report of the Chief of the Bureau of Ordnance, attached to REP. SEC'Y NAVY (1905), 45-47.

The first attempt to limit profits by statute had thus threatened to cut off production of armor entirely. Profiteering in munitions and supplies was prevalent during the Spanish-American War, as in the Civil War.[18] The effort to restrict war profits by setting a top price to be paid for munitions had been a complete failure. Though price-fixing was used to some extent in the first World War, no attempt was again made to attack the overall problem of war profits by establishing top prices for munitions.

The Government relied largely on competitive bidding as a means of limiting profits on all Government contracts prior to World War I.[19] There have been recent investigations which indicate that the system of competitive bids did not perhaps achieve the lowest prices to the Government,[20] but it is difficult to draw any just comparisons between Government purchases in peacetime and purchases in wartime. In peacetime there is generally a buyers' market for war materials, while in wartime the market clearly favors the sellers.

III. World War I Profit Limitation Attempts

The outbreak of World War I found the nation, as usual, without any program whatsoever for control of munitions prices or profits. True, the Congress had in 1916 passed an act imposing a tax of 12½ per cent on the profits of manufacturers of munitions,[21] and on March 3, 1917, an act was approved providing for an excess profits tax of 8 per cent.[22] Neither of these statutes was aimed primarily at limitation of profits on war contracts; the first was largely a reflection of the spirit of the times in reacting against traffic in munitions, and the second appears to have been primarily a revenue measure.

There were three primary types of attempted profit limitations during the first World War: (1) the use of cost-plus contracts, (2) price fixing and control, and (3) excess-profits taxes. The several Congressional committees which have investigated the matter of war profits in the last war have demonstrated quite conclusively that none of these methods accomplished effective limitation of profits or prices.

The first months of World War I were marked by the confusion and lack of planning in the procurement of war matériel. For a time, there was no central coordinating agency, and there was absolutely no program for mobilization of industry to produce for war. For a time the Army and Navy tried to continue their peacetime procurement methods of purchasing from the lowest bidder. In-

[18] WALTER MILLIS, THE MARTIAL SPIRIT, A STUDY OF OUR WAR WITH SPAIN (1931) *passim; Hearings before House Committee on Military Affairs on H. R. 3 and 5293*, 74th Cong., 1st Sess. (1935) 590-598.

[19] The basic statute was Section 3709 of the Revised Statutes.

[20] SEN. REP. No. 944, 74th Cong., 1st and 2d Sess. (Nye Committee, 1935-1936); SEN. REP. No. 480, Pt. 5, 77th Cong., 2d Sess. (Truman Committee, 1942); H. R. REP. No. 576, 77th Cong., 2d Sess. (House Naval Affairs Committee, January 20, 1942).

[21] Act of September 8, 1916, 39 STAT. 756, 780.

[22] Act of March 3, 1917, 39 STAT. 1000. Excess profits were defined as profits above 8 per cent of "actual capital" plus $5000.

deed, even after January, 1918, many contracts made by the Army Quartermaster's Corps were let on this basis.[23] The initial stage of war procurement saw purchases being made on the old-fashioned bid basis, with the several Government agencies actually competing against each other in securing supplies.[24] Some agencies therefore obtained excessive quantities of supplies while others did not obtain sufficient to meet their needs, and the prices of various war supplies were inflated because of the inflated demands of the several agencies.[25] The President early established coordinating agencies to bring some order into Government procurement, starting with the Council of National Defense and ending with the War Industries Board in July, 1917.[26]

a. *Cost-plus Contracts*

The competitive bid system, however, could not continue long during wartime. As prices of raw materials and labor rose rapidly, contractors refused to take fixed-price contracts. Accordingly, the cost-plus-a-percentage-of-cost contracts were devised and came into increasing use in the early part of the war. Thus, the Secretary of the Navy noted that shipbuilders refused to submit fixed-price bids for battle cruisers.[27] The Supreme Court in the *Bethlehem Steel Corporation* case[28] approvingly quoted the 1919 report of the Chief of the Construction Division, War Department:

> Obviously no sane man would bid on a lump sum contract under such conditions, unless perchance he should treat the matter as a pure gamble and include an excessive margin in his proposal for unforeseen contingencies.

Cost-plus-a-percentage-of-cost contracts for a time supplanted all other forms of contracts for the larger purchases of the armed forces and the Emergency Fleet Corporation. Of more than $1,750,000,000 in contracts executed by the Army Ordnance Department up to the end of 1917, the Chief of Ordnance testified that the great majority of these contracts were let on the cost-plus basis.[29] As the cost-plus-a-percentage-of-cost form of contract lent itself readily to abuse, the cost-plus-a-fixed-fee contract was introduced and to some extent supplanted the other type of

[23] J. F. CROWELL, GOVERNMENT WAR CONTRACTS (1920) 21 (Carnegie Endowment for International Peace, Preliminary Economic Studies of the War, No. 25).

[24] GOVERNMENT PURCHASING—AN ECONOMIC COMMENTARY, TEMPORARY NATIONAL ECONOMIC COMMITTEE MONOGRAPH No. 19 (76th Cong., 3d Sess., 1940), 43 *et seq.*; GRASKE, THE LAW OF GOVERNMENT DEFENSE CONTRACTS (1941) 6-8.

[25] James R. Withrow, *The Control of War Profits in the United States and Canada* (1942) 91 U. OF PA. L. REV. 194, 199.

[26] For the chronological sequence of unifying agencies, see TNEC MONOGRAPH No. 19, *supra* note 24, at 45 *et seq.*; GRASKE, *op. cit., supra* note 24, at 8, 9, and BARUCH, AMERICAN INDUSTRY IN THE WAR, REPORT OF THE WAR INDUSTRIES BOARD TO THE PRESIDENT (1921), *passim*.

[27] REP. SEC'Y NAVY (1917) 30. The Naval Appropration Act of 1916 (August 29, 1916, 39 STAT. 556) had provided that the Secretary might contract for such ships "on the basis of the actual cost plus a reasonable profit to be determined by him," and the major shipbuilders all submitted bids on a cost-plus-a-percentage-of-cost basis.

[28] See United States v. Bethlehem Steel Corp., 315 U. S. 289, 302 (1942).

[29] *Hearings before the Select Committee on Expenditures in the War Department, Series I, Pt. 5,* 66th Cong., 1st Sess. (1919) 488.

contract.[30] The difficulties of determining the "actual cost" under a cost-plus contract were just as great in 1917 as they are today; in addition, there was the problem that under cost-plus-a-percentage-of-cost contracts, the contractors were tempted to increase their profits by increasing the cost. Apparently the Navy Department adopted as a basis for the determination of cost the principles set forth in the 1916 munitions profits tax act,[31] but these principles were so general in terms as to furnish no guide at all.[32] The interdepartmental conference of July, 1917 on uniformity of contracts and cost accounting condemned the percentage-of-cost system and recommended instead the use of the cost-plus-a-fixed-fee type of contract.[33]

The cost-plus-a-fixed-fee contract was by no means the answer to all of the problems inherent in procuring war supplies at reasonable cost, with reasonable profits to the contractor. In World War I, as in the present war, the cost-plus-a-fixed-fee type of contract gave rise to many difficult administrative and accounting problems; in particular, the accurate determination of costs required a very large force of skilled auditors and accountants.[34] Similarly, a desire to provide an incentive to reduce costs led to a modification of the cost-plus-a-fixed-fee contract in the form of a bonus added to the fixed fee for savings in actual cost as compared with estimated cost. It was in fact this type of contract which was before the Supreme Court in the *Bethlehem Steel Corporation* case and illustrated the tendencies such contracts have to encourage somewhat exaggerated estimates of cost.

The Army and the Navy made ostensible efforts to limit profits on the cost-plus contracts; both the War and Navy Departments included in a number of their contracts provisions specifying that profits thereon should be limited to 10 per cent of the actual cost.[35] These limitations imposed in the contracts were not effective; and apparently no effort was made to recapture profits in excess of the specified percentages. Mr. Justice Black pointed out in his *Bethlehem Steel Corporation* opinion that any citation of the 10 per cent figure as indicating average profits on cost-plus contracts during the first World War was "illusory" and "without basis in the realties of business experience."[36] A report of the Federal Trade Commis-

[30] CHARLES E. HUGHES, REPORT TO THE ATTORNEY GENERAL ON THE AIRCRAFT INDUSTRY (1918) 134, reprinted as Appendix A, 57 CONG. REC. 883, 906 (1918); H. R. REP. No. 816, 66th Cong., 2d Sess. (1918) 49-53 (Expenditures in the War Department—Camps).

[31] Act of September 8, 1916, 39 STAT. 756, §302.

[32] The Secretary of the Navy remarked that as "regards the determination of the actual cost, hardly any two accountants would agree exactly, this being a highly technical question involving a large number of factors." REP. SEC'Y NAVY (1917) 31. He further stated that the 1916 munitions tax act had been "found satisfactory in general" as a basis for cost determination, "although detail difficulties have naturally arisen."

[33] TNEC MONOGRAPH No. 19, *supra* note 24, at 50.

[34] Cf. HUGHES, *supra* note 30, wherein he stated that "contracts of this sort lead to waste, foster abuses, and impose an almost intolerable burden of cost accounting, in itself a hindrance to rapid production," noted by Mr. Justice Black in the *Bethlehem Steel Corp.* opinion, 315 U. S. 289, 306.

[35] REP. SEC'Y WAR (1917) Vol. I, 28; *id.* (1918) Vol. I, 1319; *id.* (1919) 4138-42; REP. SEC'Y NAVY (1917) 33; *id.* (1918) 685; *id.* (1920) 147-8.

[36] United States v. Bethlehem Steel Corp., 315 U. S. 289, 306-8 (1942).

sion, made in 1918 pursuant to Senate resolution, also makes it clear that profits on war contracts ran much above 10 per cent in several of the major industries.[37]

Mention should perhaps be made of the wide use of compulsory orders during World War I. Authority under the compulsory order statutes[38] was often invoked to bring about purchases at reasonable prices when the prices quoted appeared too high. No stigma was attached to the issuance of a compulsory order in World War I; in contrast, compulsory orders are rarely employed in the present war.[39] In fact, the reduction of stipulated contract prices by means of the compulsory order might be termed a primitive method of renegotiation, although the analogy is not very apt. Nevertheless, the compulsory orders in World War I were employed to a limited extent in the light of total volume of procurement, and they were utilized in place of a contract, not to change prices under already executed contracts.

b. *Price-fixing*

At the same time that the Government agencies were attempting to maintain some form of control over profits under the several forms of cost-plus contracts, the General Munitions Board, and later the War Industries Board, approached the problem from the angle of fixing prices on certain commodities. Strangely enough, no statute authorizing over-all fixing of prices was enacted during the war. The War Industries Board derived such power to fix prices as it exercised from the power granted to the President to place compulsory orders with any manufacturer,[40] and its derivative power to allocate priorities.[41] The food and fuel control act of 1917[42] gave the President very broad powers of control over prices of food and fuel products and through those powers the Food and Fuel Administration was able to exercise some authority over prices with statutory backing.

The War Industries Board established a Price Fixing Committee to fix prices for products other than foods and fuels; this Committee dealt almost exclusively with raw materials.[43] The Committee was hampered in that it did not administer the prices it set, leaving this function to the commodity sections of the War Industries Board. Its general policy was to fix prices at fairly high levels, with the result that the low-cost producers in an industry made large profits. The Board justified

[37] *Hearings before the Committee on Military Affairs on H. R. 3 and 5293*, 74th Cong., 1st Sess. (1935) 604 *et seq.* The report of the Federal Trade Commission (TAKING THE PROFITS OUT OF WAR) is one of the exhibits, pages 604 *et seq.*

[38] National Defense Act of 1916 (June 3, 1916), 39 STAT. 213, 50 U. S. C. 1940 ed. §80; Act of March 4, 1917, 39 STAT. 213, 50 U. S. C. 1940 ed. §309; Act of June 15, 1917, 40 STAT. 182. *Cf.* REP. SEC'Y NAVY (1917) 33.

[39] Present authority is Section 9 of the Selective Training and Service Act of 1940, 54 STAT. 885, 892, as amended, 50 U. S. C. 1940 ed. §309 (Appendix).

[40] *Supra* note 38.

[41] Abels, *Price Control in War and Emergency* (1942) 90 U. OF PA. L. REV. 675, 682 *et seq.*

[42] Act of August 10, 1917, 40 STAT. 276.

[43] TNEC MONOGRAPH No. 19, *supra* note 24, at 51, 52. The armed services were represented on the Price Fixing Committee, which was evidently very careful in performing its functions not to interfere with their procurement. *Cf.* REP. SEC'Y NAVY (1918) 98.

this policy by the proposition that it was concerned first of all with stimulating production, and was forced to look after the less efficient producers in order to keep the full capacity of the industry in operation. It relied on the tax laws to recover much of the excessive profits.

Ostensibly, the Price Fixing Committee set prices by agreement with the industry concerned. Thus, Mr. Baruch, in his report to the President in 1921, remarked that the "bases in law for different regulations were varied, and in some cases doubtful," and emphasized the processes of negotiation by which the Government and industry arrived at prices.[44] In point of fact, there was little about the agreements which was voluntary—they were entered into under thinly-veiled compulsion, the threat of commandeering. Mr. Baruch himself bluntly recognized this fact in later years, when he admitted that universal compliance with the price regulations was obtainable only with the aid of potential compulsion, and that "price-fixing by agreement" was as much of a euphemism as calling conscription "selective service" and referring to registrants for the draft as "mass volunteers."[45]

The attempts of the War Industries Board to fix prices (limited, as heretofore noted, largely to raw materials) did not achieve very much in the way of limitation of profits.[46] The Government in World War I ultimately relied almost entirely upon the excess-profits tax to eliminate excessive profits. It took the nation some little time, however, to come to this conclusion and to work out adequate tax laws.

c. *Excess-profits Taxes*

Mention has heretofore been made of the excess-profits tax imposed in March, 1917.[47] This statute was soon superseded by the War Revenue Act of 1917,[48] which was retroactive for the period the March law was in effect, and applied to all business, whether carried on by individuals, partnerships, or corporations. The tax was computed on the net income in excess of a specifically defined normal return (the average rate of return of the business in the years 1911-1913), not to exceed 10 per cent or be less than 7 per cent upon invested capital plus a specific credit. The rates of tax (varying from 20 per cent to 60 per cent) were graduated according to the amount by which the net income in excess of the designated normal return (rate) on invested capital exceeded specified percentages of the taxpayer's invested capital. The rate of tax on an individual or occupation "employing" no invested capital or not more than a nominal capital was a flat 8 per cent of the net income in excess of $6000.

These taxes did not adequately get at the large scale profits enjoyed by the larger Government contractors. President Wilson in a message to Congress on May 27,

[44] BARUCH, *supra* note 26, at 72 *et seq.*

[45] H. R. Doc. No. 163, 72d Cong., 1st Sess. (1931) 817 (Hearings Before War Policies Commission). The legal section of the War Industries Board on June 18, 1918, concluded that a threat to commandeer expressed in the form of a contract to induce the fixing of the price did not constitute duress. Abels, *supra* note 41, at 684.

[46] GROSVENOR B. CLARKSON, INDUSTRIAL AMERICA IN THE WORLD WAR (1923) 322; FTC report, *supra* note 37, *passim*.

[47] *Supra* note 22.

[48] Act of October 3, 1917, 40 STAT. 300.

1918, indicated the need for a new tax bill to curb the profiteering which he noted was indisputable.[49] Shortly thereafter, the Senate passed a resolution requiring the Secretary of the Treasury to submit information on war profits, specifically, to report all corporations which had earned over 15 per cent on their capital stock in 1917, and the 1916 profits of such corporations.[50] On June 10, 1918, another resolution was passed (both resolutions having been submitted by Senator Borah), directing the Federal Trade Commission to report on profiteering.[51] The Commission's report was specific in indicating that profiteering existed in many lines.[52] Pursuant to the earlier resolution, the Treasury Department's report was submitted on July 5, 1918; it showed high profit percentages and large salaries.[53]

After obtaining these factual studies, Congress finally enacted a tax law which in effect carried out President Wilson's program.[54]

The 1918 law changed the coverage of the tax to include only corporations.[55] The 1918 law set up a new standard of normal income and added a war-profits tax to be paid to the extent that it exceeded the excess-profits tax. The war-profits tax was 80 per cent of the excess of the net income of the taxpayer over the war-profits credit, which consisted, roughly speaking, of an average of the income for the three pre-war years (1911-1913) plus $3000, with the further provision that the minimum war-profits credit should be 10 per cent of the invested capital. The result of the application of this rather complicated formula, as was pointed out by the Nye Committee,[56] was that corporations with meager pre-war incomes were assured of at least a 10 per cent return, free from the war-profits tax, but if they were fortunate enough to have a high rate of earnings before the war they were enabled to get an additional exemption. The 80 per cent rate of the war-profits tax was thus not imposed upon the entire profits of the corporation, but only upon the excess over the average pre-war income.

The 1918 tax act retained the excess-profits tax as an alternative, to be paid if it was higher than the war-profits tax. The maximum excess-profits tax rate was 65 per cent, and the excess-profits credit was fixed at 8 per cent of the invested capital for the taxable year plus $3000.

The excess-profits tax was retained after the war with reduced rates. The 80 per cent rate and the war-profits credit were abandoned, and the maximum excess-profits rate was dropped to 40 per cent for 1919 and 1920. While the rates were

[49] 56 CONG. REC. 7115 (1918).

[50] *Sen. Res. No. 253*, 56 CONG. REC. 7231 (1918) (65th Cong., 2d Sess.); *id.* at 7419 (1918).

[51] *Sen. Res. No. 255*, 56 CONG. REC. 7558 (1918) (65th Cong., 2d Sess.).

[52] *Sen. Doc. No. 248*, 56 CONG. REC. 8458-62 (1918), also printed in *Hearings before House Committee on Military Affairs on H. R. 3 and H. R. 5293*, 74th Cong., 1st Sess. (1935) 604 *et seq.* Later the Commission made reports on profits in several industries, *e.g.* COST REPORTS OF THE FEDERAL TRADE COMMISSION—COPPER, June 30, 1919.

[53] *Sen. Doc. No. 259*, 56 CONG. REC. 8671 (1918).

[54] Revenue Act of 1918, 40 STAT. 1057 (approved February 24, 1919).

[55] The House Ways and Means Committee recommended this action because of the administrative difficulties in administering the excess profits tax as to individuals and because of the feeling that the heavy income surtaxes would render substantial justice between individual and corporate taxpayers.

[56] SEN. REP. No. 577 ON H. R. 5529, 74th Cong., 1st Sess. (1935).

thus reduced for the years after 1918, the Revenue Acts did contain a provision designed to continue the application of the 1918 war-profits tax rates to profits on war contracts entered into during the period April 6, 1917, to November 11, 1918. Under the 1918 act the net income remaining after the deduction of the war-profits and excess-profits taxes was subjected to a normal corporation tax of 12 per cent for 1918 and 10 per cent for 1919 and 1920. The excess-profits tax expired in 1921.

The pivotal figure in the computation of the excess-profits tax was, of course, the computation of invested capital. Invested capital was made up on an historical or cost basis—it included cash paid in for shares, paid in or earned surplus and undivided profits (not including surplus and undivided profits earned during the year) but excluded borrowed capital and any assets (such as corporate shares) the income from which was not included in computing taxable profit. Assets were valued at original cost, revised by the depreciation or depletion allowed. If not acquired by purchase, they were taken at their actual cash value at the time of acquisition, but rigid limitations were imposed upon the value of good will and other intangible assets paid in for stock or shares. Any writing up of assets through revaluation, reorganization after March 3, 1917, or otherwise was in general forbidden, and corporations which had written up their assets or reorganized before this date secured an enormous advantage thereby. It was extremely difficult to work out invested capital in a large number of cases, and there was a great deal of litigation on this issue.[57]

Mr. Baruch told the War Policies Commission that the World War excess-profits taxes could not capture profits due to price rises and, indeed, increased inflation because they took less than 100 per cent of profits in excess of the normal return.[58]

As a revenue measure, the excess-profits tax appears to have been successful in World War I. Its yield became the largest source of revenue apart from borrowings; the average yield of the tax during the three-year period 1917 to 1919 was almost $2,000,000,000, or more than one-fourth of the entire ordinary receipts of the Government. Apparently it was paid during the war without too much complaint or hardship, in part because of the enormous profits being made by Government contractors, and in part because of the relief provisions of the law and administrative regulations. The World War excess-profits tax was administered as a tax measure to bring needed funds into the Treasury. The Assistant Secretary of the Treasury estimated that taxes during the war absorbed about 70 per cent of

[57] The Nye Committee points to the history of the Newport News Shipbuilding and Dry Dock Company's controversy with the Government on this subject. It took until 1931—14 years—to settle the company's 1917 taxes because of the difficulties of determining invested capital, and then settlement was made by the Bureau of Internal Revenue only because it finally gave up and decided that it could not determine the company's invested capital but would make a special assessment. Under the assessment, the exemption was the same percentage of the company's net income as the average exemption of representative concerns in the same or similar business was of the average net income of such concerns. SEN. REP. No. 944, Pt. 2, 74th Cong., 1st Sess. (1935) 21.

[58] H. R. DOC. No. 163, 72d Cong., 1st Sess. (1931) 798 (Hearings before War Policies Commission).

the increase of the average profits of the war years over the average profits for the years immediately before the war.[59] The Nye Committee challenged these figures and calculated that only 44 per cent of the increase of war-years profits over pre-war profits was taken in taxes.[60] Whichever percentage is taken, it is evident that there was a very wide margin for substantially increased profits arising out of the war. The controversies as to the taxes appeared to arise largely in the post-war years when the taxpayer might be confronted with additional claims for taxes, not contemplated during the war when he paid taxes, however patriotically, on the basis of his own returns.

After 1919, as profits declined, the law was subjected to considerable attack and many taxpayers collected large refunds. In 1920, Secretary of the Treasury Houston described the complexities of the income and profits taxes as "clogging the administrative machinery and threatening, indeed, its possible breakdown." Tax evasion and tax avoidance became far more prevalent after the war.[61]

The excessive administrative burden of the World War I excess-profits tax, the difficulties with invested capital determinations, the rigidity of the application of the tax, and its failure to reach a large segment of war profits, all indicate that the excess-profits tax, on the basis of such World War experience, is not alone sufficient to cope with the problem of war profits.

IV. CONSIDERATION OF WAR PROFIT LIMITATIONS BETWEEN THE TWO WARS

Following the first World War the Government returned to competitive bidding as the method for keeping profits down on Government contracts. This was the major safeguard until 1940, although with the passage of the Vinson-Trammel Act in 1934, Congress applied the percentage of cost limitation of profits formula to a substantial dollar volume of Government contracts. In 1940, Congress turned again to the excess-profits tax as a means of attacking the limitation of profits on a general basis. The excess-profits tax, plus certain statutes limiting profits on cost-plus-a-fixed-fee contracts to specified percentages, constituted the main instrument of profit limitation up to the passage of the renegotiation statute on April 28, 1942.[62]

During the 23-year period between the armistice ending World War I and the outbreak of the present war, Congress considered approximately 200 bills and resolutions dealing, in one way or another, with the limitation of war profits. Of this number, less than one-fourth received serious consideration. No bill dealing with the entire problem of war profits became law. Certain statutes were enacted limiting profits to fixed percentages of price or cost of some munitions, but these statutes were peacetime measures, not designed to deal with war profits. The Second Revenue Act of 1940, imposing an excess-profits tax, may be described as

[59] H. R. Doc. No. 163, 72d Cong., 1st Sess. (1931) 689, 690 (Statement of Arthur Ballantine to the War Policies Commission).
[60] SEN. REP. No. 944, Pt. 2, 74th Cong., 1st Sess. (1935) 13-15.
[61] *Id.* at 44 *et seq.*
[62] 56 STAT. 245, 41 U. S. C. A., note prec. §1 (Supp. 1942).

an effort to limit profits on war contracts. Reliance was placed on the excess-profits tax in the period between October 8, 1940 (date of approval of the Revenue Act) and the enactment of the renegotiation statute (April 28, 1942).

a. *1919-1934*

The investigations conducted during this period between the two wars indicated much criticism of and dissatisfaction with the attempts at profit limitation during World War I. It was not until 1924 that Congress began to study certain bills designed to limit war profits. Meanwhile, some effort had been made to set up a planning agency to program more efficiently the mobilization of industry in the event of war. Because of the shockingly poor record of the Government in World War I in getting munitions to the actual theaters of combat,[63] the immediate consideration for the armed services was the establishment of some overall program for the rapid transformation of industry to wartime production.

The National Defense Act of 1920[64] was the first result of this pressure to increase the efficiency of wartime procurement and it directed the Assistant Secretary of War to make "adequate provision for the mobilization of material and industrial organizations essential to wartime needs." The War Department expended considerable effort in drawing up a program of industrial mobilization for war.[65] While elements of the program were utilized as the nation prepared for the present war, it was never put into operation. By joint order of the Secretaries of War and the Navy, the Army-Navy Munitions Board was established in 1922 to coordinate procurement by the two services.[66] All of these efforts were directed primarily at a more efficient and speedy method of wartime procurement; the planning did touch upon the prevention of war profits, but this essentially more difficult (though less important) problem was not emphasized.

The American Legion was instrumental in 1922 in having introduced in Congress the Capper-Johnson bill to deal with limitation of war profits.[67] This bill was sweeping in its terms, and while efforts were made to secure favorable action upon it, the Congress did not consider it.[68] At the same time, Representative John J. McSwain of South Carolina introduced a joint resolution to create a special Federal Commission to investigate the whole subject of war profits and to recommend

[63] TNEC MONOGRAPH No. 19, *supra* note 24, at 53.

[64] 41 STAT. 759, 764, 765 (1920).

[65] REP. SEC'Y WAR (1937) 27.

[66] The Joint Board (established by a joint order of the Secretaries of War and of the Navy, dated July 17, 1903) established the Army-Navy Munitions Board by letter of June 27, 1922, approved by the Secretaries of War and of the Navy on June 29, 1922. By Executive Order 9024 of January 16, 1942, the Army-Navy Munitions Board was directed to report to the President through the Chairman of the War Production Board. By organization order of February 21, 1942, the Under Secretaries of War and of the Navy established the membership of the Board as the Under Secretaries and a civilian chairman appointed by them.

[67] H. R. 13201, 67th Cong., 4th Sess., introduced December 6, 1922. The American Legion looms rather large in actively sponsoring or supporting many of the efforts to control war profits; it was instrumental in having a number of bills introduced in the middle 30's.

[68] H. R. REP. No. 808 ON H. R. 6704, 75th Cong., 1st Sess. (1937), a report of the House Military Affairs Committee.

legislation.[69] Both the Republican and Democratic party platforms in 1924 contained plans for the mobilization of industry in time of war and the control of profits to be realized from war production. The American Legion, among others, continued to press for favorable action in this matter, and finally in 1930, the McSwain Resolution, then known as the Wainwright-Snell Resolution, was passed.[70]

Prior to this time, however, the Congress had not given any very serious attention to the elimination of war profiteering. In 1924 and in 1928 the Committee on Military Affairs of the House of Representatives had held hearings on several comprehensive bills dealing with war mobilization and elimination of profiteering, but no action was taken on these bills.[71]

Thus, the attempt to come to grips with the lack of organization and confusion which characterized the first months of World War I culminated in the passage of a resolution which created a commission "to study and consider amending the constitution of the United States to provide that private property may be taken by Congress for public use without profit during war and methods of equalizing the burdens and to remove the profits of war, together with a study of policies to be pursued in event of war." The Joint Executive and Congressional Commission, the so-called War Policies Commission established pursuant to this resolution, conducted extensive hearings, brought out the inadequacies of the procurement procedures of World War I (particularly through the testimony of Mr. Bernard M. Baruch), and made several reports to Congress.[72] Its recommendations were primarily concerned with setting up methods of speedy and orderly procurement. It endorsed the decision to abandon competitive bidding of war munitions in time of war.[73] The War Policies Commission did enter the field of profit limitation in recommending that a constitutional amendment be passed to eliminate all doubts as to the power of Congress to prevent profiteering, and further, that in time of war individuals and corporations be taxed 95 per cent of all the income above the previous three years' average.[74] There is no doubt that world-wide economic and political unrest spurred the Congress and the War Policies Commission to consider more carefully and intensively the procurement and economic problems attendant upon war. The Creditanstalt crashed in Vienna in 1931; Japan in the same year attacked Manchuria, and in 1933 withdrew from the League of Nations.

In 1932, the Senate took up the recommendation of the War Policies Commission that a tax of 95 per cent of excess-profits tax be imposed in time of war, by passing Senate Resolution No. 180,[75] which referred such recommendation to the

[69] H. J. RES. 400, 67th Cong., 4th Sess., introduced December 6, 1922.

[70] PUB. RES. No. 98, 71st Cong., 2d Sess., approved June 27, 1930, 46 STAT. 825.

[71] House Committee on Military Affairs: *Hearings on H. R. 4841, H. R. 8111, H. J. Res. 128,* 68th Cong., 1st Sess. (March 11, 13, 20, 1924); *Hearings on H. R. 455, H. R. 8313, H. R. 8379,* 70th Cong., 1st Sess. (1928). *Cf.* also, before Senate Military Affairs Committee, *Hearings on S. 1620,* 69th Cong., 1st Sess. (1926); SEN. J. RES. 20, 71st Cong., 1st Sess. (1929).

[72] REP. WAR POLICIES COMM., H. R. Doc. No. 163, 72nd Cong., 1st Sess. (1931); *id.* H. R. Doc. No. 264, 72nd Cong., 1st Sess. (1932).

[73] H. R. Doc. No. 163, 72nd Cong., 1st Sess. (1931) 363.

[74] H. R. Doc. No. 264, 72nd Cong., 1st Sess. (1932).

[75] Adopted March 8, 1932, 72nd Cong., 1st Sess.

Secretary of the Treasury for his comments and opinions. The response of the Secretary of the Treasury indicated that he did not believe enactment of such a tax would solve the problem.[76] He began by pointing out that the "ideal war-income tax would bring into the Treasury the entire amount of profits due to the war." The Secretary reviewed the World War I experience with excess-profits taxes and concluded that on the basis of such experience the suggestion to tax 95 per cent of all income above the three-year average prior to the war was unworkable. Portions of the excess profits, he noted, were in the form of inventories and improvements or additions to factories; a five per cent margin was too small a safety factor in view of the inevitable inaccuracies in calculating profits; invested capital as a basis for measuring the excess of income was very unsatisfactory and "should not be used again except as a last resort"; and the suggested rate might work great hardships in the case of individuals and encourage the payment of excessive salaries by corporations.

b. *The limitation of the Vinson-Trammel Act*

Following the reports of the War Policies Commission and of the Secretary of the Treasury with respect to the Commission's excess-profits tax recommendation, a number of bills and resolutions dealing rather generally with profit limitation were introduced. The request in 1934 that the Congress appropriate funds to build up the Navy to its treaty strength was the occasion for a spirited discussion in the Congress as to the limitation of profits on munitions and led ultimately to the incorporation in the Vinson-Trammel Act, authorizing the expansion of the Navy, of a flat percentage limitation of profits.[77] The proposal to build up the Navy brought forth a considerable amount of criticism.[78] The whole matter of the excessive profits enjoyed in the first World War was brought very much to the fore, and the Congress, which had in the years following World War I done little except authorize one major investigation, finally resolved to take some steps to limit profits. Shortly after H. R. 6604, the Vinson-Trammel bill, became law (March 27, 1934), the Senate debated and passed a resolution authorizing Senator Nye to begin his investigations of the munitions industry.[79]

Section 3 of the Act to establish the Composition of the Navy (the Vinson-Trammel Act) provided that the Secretary of the Navy should not make contracts for the vessels therein authorized unless the contractor agreed to pay into the Treasury all profit, as determined by the Treasury Department, in excess of 10

[76] SEN. DOC. No. 105, 72nd Cong., 1st Sess. (1932) (Letter from the Secretary of the Treasury in response to S. Res. No. 180).

[77] 48 STAT. 505 (1934), 34 U. S. C. 1940 ed. §496.

[78] The President had authorized the use of some $238,000,000 of P.W.A. funds for building ships for the Navy, and the subsequent request by the Secretary of the Navy for additional funds aroused a general discussion of naval policy and of profits on naval shipbuilding. 78 CONG. REC. 1586 *et seq.*, 1601 (1934). Senator Borah delivered his "Take the Profits out of War" speech. 78 CONG. REC. 3688 *et seq.* (1934).

[79] SEN. RES. No. 206, 73rd Cong., 2d Sess., adopted April 12, 1934.

per cent of the total contract price. Any subdivision of a Navy contract or subcontract[80] thereunder involving an amount in excess of $10,000 was to be subject to the conditions to which the prime contractor agreed. The Act further provided that, if the excess profit were not voluntarily paid, the Secretary of the Treasury might collect it by the methods usually employed for collecting income taxes.[81] The contractor was to make available for inspection and audit all books and records. The method of ascertaining the amount of excess profit was to be determined by the Secretary of the Treasury in agreement with the Secretary of the Navy;[82] credit was to be made for Federal income taxes paid or to be paid on the amount of such excess profit.[83]

As the method of percentage profit limitation was the only method put into operation by Congress for the period 1934-1940, the chronological discussion of the various proposals for limiting profits is interrupted to give a brief résumé of the Vinson-Trammel type of limitation during that period. By the Act of June 25, 1936, the Vinson-Trammel Act was amended to make it somewhat more flexible.[84] This amendment provided that the 10 per cent limitation should be applied to the total contract prices of all contracts made during the taxable year; thus, losses on some contracts could be offset against excess profits on others. Also provision was made allowing net losses on contracts for the preceding taxable year to be deducted in determining net profits for the current taxable year.

When Congress determined to build up the merchant marine, it incorporated in the Merchant Marine Act of 1936 the 10 per cent limitation of the Vinson-Trammel Act as to contracts for the construction of merchant ships by the Maritime Commission.[85] The Merchant Marine Act added certain directions as to computing costs and excess profit. No salary of more than $25,000 per year was to be considered a part of the cost of building a ship in computing excess profit;[86] furthermore, the Maritime Commission was directed to scrutinize construction

[80] In Aluminum Co. of America v. Commr. of Internal Revenue, 47 B. T. A. 543 (1942), the Board of Tax Appeals narrowly construed the word "subcontract" appearing in the statute. The case is pending on appeal to the Circuit Court of Appeals for the Third Circuit.

[81] The Revenue Act of 1939, approved February 10, 1939, specified that the Secretary of the Treasury should collect excess profits not voluntarily paid as required by the Vinson-Trammel Act and that all provisions of the Revenue Act of 1934, 48 STAT. 683 (1934), including penalties, were to be applicable. 53 STAT. 112 (1939), 26 U. S. C. 1940 ed. §§650, 651.

[82] The first joint order determining the method of ascertaining the amount of excess profit was T. D. 4434 issued in May, 1934. This was amended by T. D. 4723 (January 6, 1937) and T. D. 4861 (September 19, 1938). T. D. 5000 was promulgated August 15, 1940, and thus was applicable only for 2 months. Until April, 1942, however, T. D. 5000 was applied as the basis for determining reimbursable costs under most Army and Navy cost-plus-a-fixed-fee contracts; it is still used today, by the Army particularly, and for some Navy contracts.

[83] *Cf.* Section 3806 of the Internal Revenue Code, added by the Revenue Act of 1942, 56 STAT. 798, 26 U. S. C. A. §3806 (Supp. 1942), with respect to renegotiation.

[84] 49 STAT. 1926 (1936), 34 U. S. C. 1940 ed. §496.

[85] 49 STAT. 1985, 1998 (1936) §505, 46 U. S. C. 1940 ed. §1155.

[86] *Cf.* par. 45 of EXPLANATION OF PRINCIPLES FOR DETERMINATION OF COSTS UNDER GOVERNMENT CONTRACTS, put out by the War and Navy Departments in April, 1942; this paragraph also provides for a top limit of $25,000 on salaries as allowable cost under a Government contract.

costs and overhead expenses to determine whether they were "fair, just, and not in excess of a reasonable market price."[87]

The Act of April 3, 1939[88] first extended the percentage profit limitation to cover Army aircraft contracts. The Vinson-Trammel Act was further amended to provide that the 10 per cent of the contract price limitation applied only to naval vessels, and that 12 per cent was to be allowed on contracts for military or naval aircraft. This statute also specified that a net loss or deficiency in profit, due to failure to earn the permitted 12 per cent in any taxable year, might be deducted during the next four taxable years in determining the excess profits. Also, in this same month of April, 1939, the Secretary of the Navy was authorized to enter into defense construction contracts on a cost-plus-a-fixed-fee basis, with the fee limited to 10 per cent of the cost of the contract exclusive of the fixed fee.[89]

Public Law No. 671, 76th Congress, approved June 28, 1940 (the Navy "Speed-Up" Act),[90] completed the experimentation with the Vinson-Trammel Act. This Act changed the percentages to define excess profit as that in excess of 8 per cent of the total contract prices completed within a taxable year, or 8.7 per cent of the total cost of performing such contracts, whichever was the lower, and to limit the application of the Act to contracts in which the award exceeded $25,000 ($10,000 previously).[91] It may be said that all of these statutes establishing percentage limitations (with the possible exception of the last) were straight peacetime measures, not designed to deal with profits of contractors under a full wartime procurement program.

On September 9, 1940, the profit limitation provisions of the Vinson-Trammel Act, as amended, were limited to contracts for the construction of naval vessels.[92] With enactment of the Second Revenue Act of 1940 (October 8, 1940), the Congress attempted to attack the problem of profits generally on munitions contracts by means of the excess-profits tax,[93] and accordingly it suspended the profit limitation statutes applicable to all Army and Navy and to most Maritime Commission contracts and subcontracts, entered into after December 31, 1939, or uncompleted on that date by contractors and subcontractors subject to the excess-profits tax imposed by Title II of the Revenue Act.[94]

The Vinson-Trammel Act and its amendments must be written off as a failure,

[87] See regulations by the Maritime Commission under Merchant Marine Act, PRENTICE-HALL, GOVERNMENT CONTRACTS, par. 22, 987.

[88] 53 STAT. 555, 560 (1939) §14, 34 U. S. C. 1940 ed. §496.

[89] Act of April 25, 1939, 53 STAT. 590, 591.

[90] 54 STAT. 676, 677 (1940), 41 U. S. C. 1940 ed., note prec. §1.

[91] Regulations were prepared jointly by the War, Navy and Treasury Departments: T. D. 4906, 4909 and 5000 (June 23, 1939, June 28, 1939, August 15, 1940).

[92] 54 STAT. 875, 883 (1940), 41 U. S. C. 1940 ed. note prec. §1.

[93] H. R. REP. No. 2894, 76th Cong., 3d Sess. (August 29, 1940), a report of the House Ways and Means Committee on H. R. 10413.

[94] The Treasury Regulations on limitation of profits were suspended. *Cf.* T. D. 5034 (1941). T. D. 5000, however, is still used by the Navy Department in determining allowable costs under some cost-plus-a-fixed-fee contracts. The Vinson-Trammel Act provisions may be revived by proclamation of the President or joint resolution of Congress.

even in peacetime, in accomplishing any effective profits control. According to a statement of the Treasury Department, the net amount assessed under the Act on contracts for Navy vessels and aircraft up to August 31, 1942, was roughly $7,450,000, and on Army aircraft contracts for the same period, $70,000.[95] As plans for vastly increased procurement of war munitions were made after the fall of France in 1940, it was established that the Vinson-Trammel Act limitations were making shipbuilders and aircraft manufacturers reluctant to enter into contracts and were definitely delaying the war program.[96] Investigations of profits on the contracts of the armed forces, after suspension of the Vinson-Trammel Act, have quite conclusively established that the Act was ineffectual to prevent very large profits to certain contractors.[97]

c. *Investigations and Discussion, 1934-1940*

During this period 1934 to 1940, when the percentage profit limitation statutes were in force, the Congress did consider a number of other methods for eliminating excessive profits of war contractors. The Nye Committee's reports constituted perhaps the most exhaustive investigation of war profits limitations; the Committee was extremely critical of the ineffectiveness of the World War I attempts to limit profits, and seriously considered nationalizing the American munitions industry.[98] The Congress was conscious of war profits during this period as it had never been before. Again its activities should be viewed in the perspective of international events—in 1935 Mussolini marched into Ethiopia; in 1936 Spain became embroiled in civil war; and in 1937 Japan began to wage "active" war against China and Hitler started the series of moves which led to Munich and the outbreak of European war. Despite the publicity surrounding the Nye Committee hearings and the vast amount of literature to the effect that the munitions-makers had pushed the nation into World War I, the Congress was not unaware of the possibility that the nation might be drawn into some future war. Certainly there had never been so much study before any other war in our history as to the most efficacious war mobilization and control of the war economy.

On March 2, 1934, about a month before the Nye Committee was established, the House had passed House Resolution No. 275 (73d Congress), authorizing the House Military Affairs Committee to investigate alleged profiteering on Government contracts, particularly Army aircraft contracts. The preamble to this resolution as originally introduced indicated that it was passed in part because there

[95] Statement by the Treasury Department submitted by Senator Walsh, *Hearings before a Subcommittee of the Senate Finance Committee on Section 403 of Public Law 528*, 77th Cong., 2d Sess. (September 29 and 30, 1942) 96.

[96] See debate on the 1940 excess-profits tax bill, 86 CONG. REC. 11, 243 (August 29, 1940).

[97] *Cf.* SEN. REP. No. 480, Pt. 5, 77th Cong., 2d Sess. (January 15, 1942) 87 (Truman Committee); H. R. REP. No. 1634, 77th Cong., 2d Sess. (January 20, 1942), a report of the House Naval Affairs Committee pursuant to H. RES. No. 162.

[98] SEN. REP. No. 944, Pts. 4, 5 and 7, 74th Cong., 2d Sess. (1936). See S. 2603, 75th Cong., 1st Sess., introduced by Senator Nye on June 8, 1937, providing that the Secretaries of War and of the Navy should acquire facilities to supply all war munitions.

were "a number of bills pending before the Committee on Military Affairs of utmost importance to the problem of national defense in general, and to the operations of the War Department."[99]

1. *H. R. 5529, 74th Congress (1935)—American Legion Bill*

H. R. 5529, 74th Congress, introduced by Representative McSwain of South Carolina February 7, 1935, apparently was the first comprehensive bill to mobilize production in time of war and to take the excessive profits out of war production which was extensively considered by both Houses.[100] Title I of this bill comprised a complete revenue act for wartime purposes. As passed by the House of Representatives on April 11, 1935, section 8 of Title 1 provided that "upon the declaration of war there shall be imposed a tax of 100 per centum of all excess profits that may be earned during said period of war as defined in this Act." After passage by the House the bill was referred successively to the Nye Committee, the Senate Military Affairs Committee and the Senate Finance Committee, all of which held hearings and made reports upon the bill. The Nye Committee concluded that H. R. 5529, as approved by the House, relied primarily upon price-fixing to control profits, and recommended that a comprehensive excess-profits tax be adopted as the most useful weapon to limit war profits.[101] The Nye Committee, it is true, also considered the excess-profits tax as vital for producing revenues to finance the war. After the bill had been very drastically revised by the three Senate Committees, it was allowed to lapse in the Senate.

Meanwhile, the House in January, 1935, had held hearings on two bills approaching the limitation of profits as a part of a broad scheme of economic mobilization in time of war; these hearings are instructive in bringing out some of the shortcomings of World War I attempts.[102] These two bills were never reported out by the House Committee, apparently because other bills covering the same subject matter were receiving major consideration at the time.

[99] The preamble was stricken when the resolution was adopted, 78 CONG. REC. 3622 (1934). This resolution was prompted in large part by the accidents which occurred following the take over of the air-mail routes by the Army. See 78 CONG. REC. 3613-3622 (1934). The authority granted the Committee by this resolution was extended by H. R. RES. No. 59, 74th Cong., adopted January 18, 1935.

[100] This bill was sponsored by the American Legion, and also by Mr. Baruch. *Cf.* H. R. REP. No. 808 ON H. R. 6704, 75th Cong., 1st Sess. (1937) 2.

[101] SEN. REP. No. 577, 74th Cong., 1st Sess. (May 3, 1935) (also printed with the report of the Senate Military Affairs Committee, SEN. REP. No. 889, 74th Cong., 1st Sess., June 14, 1935). The Senate Military Affairs Committee considered primarily the industrial mobilization features of the bill and recommended that the tax provisions be referred to the Senate Finance Committee. SEN. REP. No. 889, 74th Cong., 1st Sess.. (June 14, 1935). The Finance Committee considered the measure both as a means of eliminating excessive profits and as a means of providing revenues. SEN. REP. No. 2337, 74th Cong., 2d Sess. (June 10, 1936). It rewrote the tax provisions of H. R. 5529 almost entirely. The Finance Committee provided for amortization of war facilities, contrary to the recommendations of the Nye Committee. SEN. REP. No. 2337, *supra*, at 17.

[102] *Hearings Before the Committee on Military Affairs on H. R. 3 and 5293*, 74th Cong., 1st Sess. (1935) (Taking the Profits out of War).

2. *War Department Industrial Mobilization bills (1935)*

The War Department had prepared industrial mobilization and draft bills which were to be submitted to Congress upon a declaration of war. These bills were introduced in the Senate without prejudice early in 1935, in order to stir up discussion prior to the outbreak of any war.[103] They were referred to the Nye Committee, which reported upon them on June 2, 1935.[104] The Committee noted that the proposed legislation relied primarily on price-fixing and taxation "to check profiteering by industry in general and to eliminate the basic war evils of inequality and inflation"[105] and warned that neither of these methods could provide an adequate answer to excessive war profits.

3. *Sheppard-May bill, Nye bill, and related bills (1937 and 1938)*

The next major consideration of the economic problems raised by war and of the elimination of excessive profits was the Sheppard-May bill, introduced in both houses on January 6, 1937.[106]

The Sheppard-May bill was sponsored by the American Legion and was also supported by Mr. Baruch and the Secretaries of War and the Navy.[107] Section 9 of the Senate bill specified that upon the declaration of war "there shall be imposed a tax of 95 per centum of all income above the previous three-year average, with proper adjustments for capital expenditures for war purposes by existing or new industries." The Secretary of War made the following rather oblique comment about this provision:[108]

"Section 9 imposes an excess-profits tax to be effective during the period of war. The War Department refrains from commenting on this section, believing that other agencies of the Government are better qualified and have more direct responsibilities in connection with taxation measures. It is desired to emphasize, however, that any tax measure adopted must not remove the incentive to produce, and thus threaten the more vital activity of securing the munitions required in war."

Both the Secretary of War and the Secretary of the Navy suggested a number of amendments to the bill. The Secretary of the Navy stated in his letter to the Committee:[109]

[103] War Department bills S. 1716-S. 1722, 74th Cong., 1st Sess.

[104] SEN. REP. No. 944, Pt. 4, 74th Cong., 2d Sess. (1935).

[105] *Id.* at 33. The approach of the War Department to profit limitation in these bills was much the same as that of the War Policies Commission. *Cf.* H. R. Doc. No. 271, 72nd Cong., 1st Sess. (1932).

[106] S. 25, 75th Cong., 1st Sess.; H. R. 1954, 75th Cong., 1st Sess., the companion bill, was introduced by Representative Hill of Alabama on the same date. Nothing was done with H. R. 1954 by the House Committee on Military Affairs, and Representative May of Kentucky reintroduced substantially the same bill, as H. R. 9604, 75th Cong., 3d Sess., on February 24, 1938. A somewhat similar bill, also sponsored by the American Legion (H. R. 6704, 75th Cong., 1st Sess.), was introduced by Representative Hill on April 27, 1937, and this bill was reported out by the Committee on May 12, 1937 (H. R. REP. No. 808, 75th Cong., 1st Sess.). H. R. 6704 in its tax provisions was very similar to the later May bill (H. R. 9604). Mr. Baruch supported all of these bills, and made some rather extravagant claims for H. R. 6704 (see H. R. REP. No. 808, 75th Cong., 1st Sess. (1937) 5).

[107] See SEN. REP. No. 480, 75th Cong., 1st Sess. (1937) 2 *et seq.* (Comm. on Mil. Affairs).

[108] *Id.* at 15.

[109] *Id.* at 17.

"The current difficulties being experienced by all of the procurement agencies of the National Government due to the restrictive provisions of the Walsh-Healey Act (49 Stat. 2036) as regards the employment of labor, and the Vinson-Trammel Act (48 Stat. 505), as amended by the act of June 25, 1936 (49 Stat. 1926), restricting the profits of Government contractors seem to indicate the necessity for the removal of these restrictions to insure the smooth operation of the Government procurement services in time of national emergency.

"Tax provisions in any measure come solely within the purview of Congress, and, therefore, the only comment offered on section 9 is quoted from exhibit 1 of the first day's hearings before a subcommittee of the Committee on Military Affairs, United States Senate, Seventy-fourth Congress, first session, on H. R. 5529, May 25 and 31, 1935, 'that the tax provisions must not be of such a nature as to hinder the procurement of munitions when the necessity for their manufacture arises.'"

Senators Nye and Lundeen of the Senate Military Affairs Committee submitted a minority report on the Sheppard-May bill,[110] in which they stated that the bill represented a "very peculiar kind of bargain. It offers something for every shade of believer in what ought to be done in time of war." They criticized the excess-profits tax provisions, pointing out prophetically that our past history indicated that a period of several years of foreign war might elapse before our entry into it; that in such event there would be a substantial pre-war increase in prices and profits resulting from trade with the belligerents; and that to use the three years immediately preceding our entry into the war as the basis for determining excessive profits might result in the imposition of slight or no excess-profits taxes on many war contractors.

In fact, Senator Nye's views as to the proper type of war excess-profits type measure were embodied in S. 1331, introduced February 2, 1937.[111] Title I of this bill established a complete income tax act to supersede existing revenue acts in time of war. A tax of 100 per cent would be levied on that portion of a corporation's net income in excess of 6 per cent of the adjusted declared value of its capital stock (thus attempting to avoid the alleged disadvantages of using either invested capital or the three-year income average prior to the declaration of war as a basis for computing excess-profits).[112] The Senate did nothing with this bill, which presumably embodied the views of the Nye Committee, based on its investigations, as to the most efficacious methods of controlling war profits.[113]

[110] *Id.* at 20.

[111] 75th Cong., 1st Sess. (1937). Senators Clark (Mo.), Bone (Wash.), Vandenberg (Mich.) and Pope (Idaho) were also sponsors of this bill. At this same time, Senator Connally, then Chairman of the Senate Finance Committee, introduced a war tax bill—S. 1248, 75th Cong., 1st Sess., introduced February 1, 1937. This bill prescribed a lower schedule of tax rates than the schedule provided in the Nye bill, and based its corporate tax upon a percentage of the undistributed net income. Senator Connally in 1939 reintroduced substantially the same bill as S. 2160, 76th Cong., 1st Sess. (introduced on April 13, 1939).

[112] Various provisions were inserted in the bill to prevent undue deductions from gross income for salaries, selling costs, depreciation and depletion. Senator Nye's bill also gave the President wide powers in the field of economic control; Title III authorized him to fix prices, determine priorities, license business, and requisition materials; other titles of the bill vested very broad controls over industry in the President.

[113] Excess-profits tax bills containing features of the Nye bill were introduced in both 1938 and 1939

The House version of the Sheppard-May bill provided with respect to taxation of war profits that there should be in effect "a system of taxation which shall absorb all profits above a fair normal return to be fixed by Congress," and that the Secretary of the Treasury should make the studies required to formulate such a plan of taxation. The House Committee on Military Affairs did not report on the bill until March 1, 1938.[114] The Committee was of the opinion that 100 per cent "of all profits shown to be due to war-time business conditions" should "be taxed out of the person, firm or corporation earning such excess profits," noting that this recommendation was in accord with the earlier recommendations of the War Policies Commissoin.[115] The House bill (and, it must be granted, the Senate bill to a large extent) constituted merely a pious expression of hope as to eliminating excessive war profits, and offered no concrete means of effecting such elimination.[116]

Representative Maverick introduced on February 16, 1938 a companion bill to Senator Nye's earlier bill.[117] This bill contained only the tax provisions of the Nye bill and eliminated completely all of the industrial control provisions. Nothing was ever done with either bill.

The reappearance of the May bill and the introduction of the Maverick bill were occasioned by the President's message to the 75th Congress on January 28, 1938,[118] in which he stated:

"I believe that the time has come for Congress to enact legislation aimed at the prevention of profiteering in time of war and the equalization of the burdens of possible war. Such legislation has been the subject for many years of full study in this and previous Congresses."

In response to the President's message, a number of new bills were introduced in the early months of 1938 dealing with the limitation of war profits, but none of those bills was considered by the Congressional Committees.[119] The sole concrete

—S. 3912, 75th Cong., 3d Sess., introduced April 27, 1938 by Senator Bone and 26 other Senators; and S. 1885, 76th Cong., 1st Sess., introduced March 21, 1939, by Senator Bone and 49 other Senators. Twelve bills introduced in the House early in 1939 were identical with the latter Senate bill (S. 1885)—H. R. 5176, 5177, 5183, 5184, 5230, 5233, 5234, 5274, 5290, 5316, 5317, and 5360 (all introduced between March 21 and 25, 1939). Both the Secretaries of War and of the Navy recommended against enactment of S. 1885 largely on the basis of the drastic change in the economic structure of the country which would be caused by making such a sweeping statute effective upon the outbreak of war. The Secretary of War recommended that the whole subject of excess profits be studied by the Treasury Department and legislation thereon be drafted and revised in peacetime, ready for presentation to Congress in emergency. See the letter of the Secretary of War dated May 5, 1939 and the letter of the Acting Secretary of the Navy dated June 7, 1939, 86 CONG. REC. 8624, 8625 (1940). All of these bills, both Senate and House, were likewise tabled and forgotten.

[114] H. R. REP. No. 1870, 75th Cong., 3d Sess. (March 1, 1938).

[115] *Id.* at 3.

[116] Note the caustic remarks contained in the minority House report, submitted by Representatives Maverick, Anderson and Kale, *id.* at 15 *et seq.*

[117] H. R. 9525, 75th Cong., 3d Sess. (1938). Senator Nye's bill, S. 1331, 75th Cong., 1st Sess. (1937), is discussed above.

[118] 83 CONG. REC. 1188 (1938). To get the proper historical background it should also be noted that this message of the President called for an increased Navy.

[119] Note H. J. RES. 585, H. R. 9391, H. R. 9408, H. R. 9525 (the Maverick bill), H. R. 9604 (the May bill), S. 3912, and H. R. 10912, 75th Cong., 3d Sess.

result of this recommendation of the President was the passage of the Act of May 17, 1938, amending the Vinson-Trammel Act and making it applicable to all contracts for the ships authorized for the increased Navy.[120]

4. *Adoption of Excess-Profits Tax Act (1940)*

In 1939 and 1940, prior to enactment of the excess-profits tax, approximately 30 bills were introduced dealing with limitation of war profits generally. As war was declared in Europe, and as war production mounted apace in this country, the Congress grew more and more insistent upon adoption of some form of excess-profits tax. With the consideration of the 1940 National Defense Tax bill in May and June, 1940, it was apparent that the Congress was going to pass some form of tax reaching profits on manufacture of munitions. Several amendments to the National Defense Tax bill[121] (which became the Revenue Act of 1940),[121a] which amendments would have provided a comprehensive tax plan for wartime profits, were adopted by the Senate but were eliminated from the bill in conference. The House Ways and Means Committee had reported out the bill without any excess-profits tax provisions of general application, but had remarked in its report[122] that it had carefully considered proposals "to provide special amortization for national defense industries and to provide for the imposition of excess-profits taxes," which it insisted should be considered together. It further noted that it had instructed its technical assistants and the Treasury officials to prepare legislation on these subjects which could be made applicable to the calendar year 1940.

The Senate Finance Committee made some substantial changes in the bill, but added no new provisions.[123] On June 19, 1940, when the bill was being debated on the Senate floor, Senator LaFollette offered as an amendment a new Title IV, providing for an excess-profits tax based on invested capital, with rates from 20 to 40 per cent of excess-profits.[124] This amendment was based on the 1921 excess-profits tax (which was merely a modification of the Revenue Act of 1918), and the experience of 1917 to 1920 with the excess-profits tax.[125] Despite the arguments raised that the matter should be more carefully considered, the Senate approved the LaFollette amendment.[126] Senator Bone then offered as an amendment another "War Profits Taxation Act," being in fact the old Nye bill of 1935,[127] which had been introduced and reintroduced a number of times. Senator Connally thereupon suggested as a substitute for Senator Bone's amendment, his own bill for excess-profits taxes, which was a direct lineal descendant of the earlier bills which

[120] *Cf.* discussion, *supra* in text to note 77 *et seq.*
[121] H. R. 10039, 76th Cong., 3d Sess. (1940).
[121a] 54 STAT. 516, 26 U. S. C. 1940 ed. §§12 *et seq.*
[122] H. R. REP. No. 2491, 76th Cong., 3d Sess. (June 10, 1940) 3.
[123] SEN. REP. No. 1856, 76th Cong., 3d Sess. (June 15, 1940).
[124] 86 CONG. REC. 8594 (June 19, 1940). [125] 86 CONG. REC. 8933 (June 22, 1940).
[126] 86 CONG. REC. 8607 *et seq.*, 8614 (June 19, 1940).
[127] 86 CONG. REC. 8619 *et seq.* (June 19, 1940). *Cf.* S. 3912, 75th Cong., 3d Sess., introduced April 27, 1938, and S. 1885, 76th Cong., 1st Sess., introduced March 21, 1939.

he had introduced.[128] Senator Connally's amendment was adopted by the Senate;[129] thus the bill as approved by the Senate contained two complete excess-profits tax measures. Both amendments were stricken in conference,[130] with the understanding that the matter of excess-profits taxes would be studied intensively and that action would be taken in the near future.

Shortly after approval of the Revenue Act of 1940, the President addressed a brief message to Congress as follows:[131]

"We are engaged in a great national effort to build up our national defenses to meet any and every potential attack. . . .

"It is our duty to see that the burden is equitably distributed according to ability to pay, so that a few do not gain from the sacrifices of the many.

"I, therefore, recommend to the Congress the enactment of a steeply graduated excess-profits tax, to be applied to all individuals and all corporate organizations without discrimination."

H. R. 10413, the excess-profits tax bill, was introduced by Mr. Doughton on August 27, 1940. This bill dealt with three related features: (1) suspension of the profit limitations under the Vinson-Trammel Act;[132] (2) the provision of amortization for defense facilities; and (3) an excess-profits tax. The House bill was a rather complicated bill which allowed excess-profits to be measured by either of two methods: average income for the base period 1936-1939, or percentage of income for the base period to invested capital for the base period,[133] with certain discriminations for corporations using the former method. The Senate Finance Committee attempted to simplify the House bill, and changed it very substantially.[134] The Senate Committee believed that the House bill, which was favored by the Treasury, was primarily a revenue raising bill rather than a prohibition of excessive war profits.[135] The Senate bill seems to have been drafted with the idea that it achieved the "average-earnings" method of computing excess-profits, rather than the "invested-capital" theory. The bill as finally adopted by both houses was an extremely complicated measure which partook of both theories,[136] and clearly

[128] S. 1248, 75th Cong., 1st Sess., introduced February 1, 1937; S. 2160, 76th Cong., 1st Sess., introduced April 13, 1939; *cf.* 86 CONG. REC. 8624, 8626 (1940).

[129] 86 CONG. REC. 8630 (June 19, 1940).

[130] H. R. REP. No. 2697, 76th Cong., 3d Sess. (June 21, 1940), a Conference Report on H. R. 10039. The bill was enacted into the Internal Revenue Code, 54 STAT. 516, 26 U. S. C. 1940 ed. §§12 *et seq.*

[131] H. R. DOC. No. 854, 76th Cong., 3d Sess. (July 1, 1940), 86 CONG. REC. 9127 (1940).

[132] Mr. Vinson stated on the floor of the House that the defense program was being delayed because of failure to suspend these provisions and to enact some excess-profits tax upon which contractors could rely. 86 CONG. REC. 11243 (August 29, 1940).

[133] H. R. REP. No. 2894, 76th Cong., 3d Sess. (August 29, 1940), a report of the Ways and Means Committee.

[134] SEN. REP. No. 2114, 76th Cong., 3d Sess. (September 11, 1940). Senator LaFollette submitted a minority report castigating the Senate bill and recommending that his own amendment to the earlier 1940 bill be adopted.

[135] 86 CONG. REC. 12057 *et seq.* (September 13, 1940).

[136] H. R. REP. No. 3002, 76th Cong., 3d Sess. (September 30, 1940), a Conference Report on H. R. 10413, which was enacted into the Excess Profits Tax Act of 1940 (October 8, 1940), 54 STAT. 974, 975 ff., 26 U. S. C. 1940 ed. §§710 ff.

represented an uneasy compromise.[137] The excess-profits tax statute was amended by the Excess-Profits Tax Amendments of 1941,[138] and by the Revenue Act of 1942.[139] The rates are now 90 per cent of adjusted excess-profits net income, as defined in the Act, or 80 per cent of the corporation surtax net income, whichever is the lesser, with a post-war refund of 10 per cent of the tax.[140] Even after enactment of the excess-profits tax statute, Congress did not rely entirely on this method of getting at profits. It retained in effect a number of statutes limiting the fees on cost-plus-a-fixed-fee contracts, and enacted a number of additional statutes limiting the fees on certain cost-plus contracts to specified percentages of the estimated cost.[141] The excess-profits tax as enacted and amended was in large part designed as a revenue measure.

The renegotiation statute adopted April 27, 1942, was aimed at the achievement of better prices to the Government in the procurement of munitions and the elimination of excessive war profits by means of more accurate pricing to the Government. Since the enactment of the renegotiation statute, there have been a number of movements in Congress to repeal the statute entirely and to rely upon the excess-profits tax for the elimination of war profits.

V. THE EFFICACY OF WARTIME PROFIT LIMITATION

The preceding chronological survey of profit limitation attempts prior to this war indicates some fairly obvious conclusions. First and foremost of all, it must be emphasized that prices and profits are not the primary consideration upon the outbreak of war. As the Under Secretary of War has recently stated in testifying as to renegotiation and alternative methods of controlling excessive war profits, the armed forces "are more interested in getting the goods than anything else."[142]

[137] 86 CONG. REC. 12922, 12923 (October 1, 1940).

[138] 55 STAT. 17 (1941), incorporated into Internal Revenue Code, 26 U. S. C. §710 (Supp. 1941).

[139] 56 STAT. 798, Act of October 21, 1942, Pub. L. 753, 77th Cong., 2d Sess.

[140] *Id.* at §§202, 250, 26 U. S. C. A. 710(a)(1), 780 (Supp. 1942).

[141] *Cf.* 54 STAT. 872, 873, 10 U. S. C. 1940 ed. §1336a (Army contracts for military posts); 54 STAT. 965, 968, 10 U. S. C. 1940 ed. §1336a (Army contracts for military posts); 55 STAT. 49, 53 (March 23, 1941) (Navy public works contracts); 55 STAT. 151, 168 (May 6, 1941) (Navy construction contracts); 55 STAT. 262 (June 24, 1941) (Navy public works contracts); 55 STAT. 366, 375 (June 30, 1941) (Army contracts for military posts); 55 STAT. 592, 593 (July 14, 1941) (Navy public works contracts) 55 STAT.; 658, 664 (August 21, 1941) (Navy public works contracts); 55 STAT. 669, 679, 681 (August 25, 1941) (Navy public works contracts, Marine Commission contracts); 55 STAT. 745, 753 (October 28, 1941) (Navy public works contracts); 55 STAT. 810, 815 (December 17, 1941) (Navy public works contracts); 55 STAT. 176, 178 (March 27, 1942) (Army and Navy contracts); 56 STAT. 314, 316 (June 5, 1942) (Army contracts for military posts); 56 STAT. 611, 632 (July 2, 1942) (Army contracts for purchase of land); Pub. L. 92, 78th Cong. (June 26, 1943) (Navy contracts for purchase of land). In addition certain statutes limiting profits to a fixed percentage remained in effect after passage of the excess-profits tax—note particularly 54 STAT. 676, 41 U. S. C. 1940 ed. prec. §1 (Navy cost-plus-a-fixed-fee contracts). Also paragraph 7 of Title II of EXECUTIVE ORDER No. 9001, dated December 27, 1941, and promulgated under the First War Powers Act, 1941, approved December 18, 1941, 55 STAT. 838, 50 U. S. C. §601 (Supp. 1941, Appendix), provides that in the absence of other applicable profit limitation statutes, the fixed-fee under any cost-plus-a-fixed-fee contract executed under the War Powers Act should be limited to 7 per cent of the estimated cost.

[142] *Hearings before a subcommittee of the Senate Finance Committee on Section 403 of Pub. L. 528*, 77th Cong, 2d Sess. (September 29 and 30, 1942) 14.

The nation must obtain large quantities of a very wide variety of munitions and war supplies as rapidly as possible. So long as the nation maintains its present form of economy based upon the profit motive, it will be necessary in many cases to pay high prices to obtain these munitions and supplies. Mr. Baruch in a letter to the Nye Committee succinctly stated the elementary truth of the matter:[143]

"Much as it may be decried, the cold fact remains that ours is an economy motivated by profits. A certain return on money is necessary to make our industrial system work. . . . Much was said at the hearing about this being a new war psychology. . . . Our whole industrial system is a complex massive machine built and geared to run on investment and profit. There is no proof that it will run on psychology and there is much that it will not. Certainly we should not select an hour when the enemy is at the gates to find out whether it will or not. . . . Money will not invest and run the extreme risks of war production for a fraction of 3 per cent."

Exactly the same point is made by the Secretaries of War and of the Navy in their comments upon the excess-profits tax bills in 1937.[144] The reports of the War Policies Commission emphasized that the nation would have to do vastly better in the way of getting munitions to the battle fronts than it had done in 1917 and 1918, and that while prices and profits would have to be carefully watched, they were of distinctly secondary importance.

There have been, in the main, three major types of attempts to limit profits on munitions contracts—specific percentage limitations on costs, price fixing and control, and taxation.

The limitation of profits to specific percentages has never worked well. The cost-plus-a-percentage-of-cost contracts constituted the first step along this line, and the experience with those contracts indicated that the Government would never again return to them. The Vinson-Trammel Act type of limitation in reality reduces all contracts thereunder to cost-plus-a-percentage-of-cost contracts, though the controls are somewhat more clearly established. The Nye Committee's report indicated that the Vinson-Trammel Act was not achieving its purposes;[145] the Committee stated that it found "from wartime experience, enough evidence of the difficulty of auditing thousands of old vouchers and of properly allocating the overhead which the companies may have improperly saddled on to Navy vessels, to declare that there is no effective profit limitation law today."[146] Later investigations have proven that this type of limitation did not prevent excessive profits even in peacetime.[147] Similarly, as the defense program was stepped up so substantially in 1940, there were indications that the Vinson-Trammel legislation was definitely impeding the placement of war contracts. This type of profit limitation has another very serious drawback in that, in the words of the Nye Committee,

[143] SEN. REP. No. 944, Pt. 2, 74th Cong., 1st Sess. (1935) (letter dated April 12, 1935, page 11, note 10).

[144] *Supra* notes 108 and 109.

[145] SEN. REP. No. 944, Pt. 1, 74th Cong., 1st Sess. (1935) 323 *et seq.*

[146] SEN. REP. No. 944, Pt. 7, 74th Cong., 2d Sess. (1936) 12.

[147] *Supra* notes 94 and 96.

"there is absolutely no effective control of costs possible without a huge policing system of auditors and inspectors constantly on the premises."[148] It is not to be denied, of course, that cost-plus-a-fixed-fee contracts have a very necessary place in the overall picture of war procurement, especially in its early phases when manufacturers are turning to products with which they are utterly unfamiliar. This proposition again, however, emphasizes the fundamental premise that the assurance of a reasonable profit to the contractors in order to get necessary supplies immediately, outweighs the consideration of more efficient methods of limiting profits.

Turning next to price controls, the limited experience of the Spanish-American War and the attempt during the early months of the first World War to use price-fixing as the main method of eliminating excessive profits in munitions manufacture has indicated the ineffectuality of this method. In World War I, in order to obtain the necessary production by marginal producers, prices were set at a high enough level to insure a profit to high cost manufacturers. The establishment of a single price for both low and high cost producers resulted, however, in tremendous profits for the former.[149] If different prices are set for different producers so that each will receive his cost of production plus a reasonable profit, the net result is that each producer has a cost-plus contract. In addition, the problems of enforcement of price regulations are enormous. General MacArthur, then Chief of Staff, told the War Policies Commission that evasion was inevitable if prices of munitions were set at peacetime levels, and that "in the end the Government's efforts would probably be largely gesture."[150] The personnel selected to administer price control and having the essential experience are inevitably either drawn from the industries over which they are to exercise control, or must be guided by the advice of businessmen from that industry. World War I experience proved that there will undoubtedly be a favorable attitude to industry in fixing the price levels. Robert R. Brookings, Chairman of the World War Price Fixing Committee, frankly told representatives of the nickel industry:[151]

"We are not in an attitude of envying you your profits; we are more in the attitude of justifying them if we can. That is the way we approach these things."

Finally, experience with excess-profits taxation in the World War I and prior to this war has not been such as to indicate that this method satisfactorily limits war profits.[152] The difficulties of working out a satisfactory formula which will eliminate the profits attributable to war and leave the necessary incentives to produce are almost insuperable. The chief stumbling block heretofore has been the determination of a valuation base upon which to determine the percentage of allowable return. The difficulties of fixing valuations of railroads and public utilities are analogous to the problems which the tax authorities faced in World

[148] SEN. REP. No. 944, Pt. 4, 74th Cong., 2d Sess. (1936) 324.
[149] SEN. REP. No. 944, Pt. 2, 74th Cong., 1st Sess. (1935) 56 *et seq.*
[150] H. R. Doc. No. 163, 72nd Cong., 1st Sess. (1931) 372.
[151] SEN. REP. No. 944, Pt. 2, 74th Cong., 1st Sess. (1935) 5.
[152] Note particularly SEN. REP. No. 480, 75th Cong., 1st Sess. (1937); SEN. REP. No. 944, Pt. 2, 74th Cong., 1st Sess. (1935).

War I in applying the invested capital base.[153] The burden placed upon the authorities charged with the administration of an excess-profits tax act are vast indeed, especially in the light of the necessary discretion which must be placed in such authorities in administering such act.

The case for the excess-profits tax as the primary means of limiting war profits has recently been presented to the House Ways and Means Committee.[154] The reasons most cogently urged on behalf of the excess-profits tax are the fact that it allows the contractor to know or to estimate accurately what his net profits on war production will be, and that it is a stabilizing factor in presenting a standard for determining excessive profits. These arguments misplace the emphasis entirely; the essential purpose of profit limitation in wartime must be the achievement of more accurate and reasonable prices to the Government and, while certainty is desirable, it must always be sacrificed to the broader interests of the Government.

The Truman Committee early this year investigated the administration of the renegotiation statute. Its report succinctly stated the reasons why the attempts at profit limitation prior to this war had never been successful:[155]

"(1) Because of the wartime need for rapid procurement of materials of war, new materials with which there has been no previous manufacturing experience and other articles previously manufactured only in relatively small quantities, some procedure for subsequent price adjustment is necessary and desirable if excessive war profits and costs are to be avoided.

"(2) Taxes alone will not do the job because (a) higher corporate tax rates are likely to encourage higher costs and discourage economical production; (b) no scheme of taxation has been devised which is sufficiently flexible to provide an incentive for efficient low-cost production; (c) a profit percentage which would fairly reward one war contractor with a different financial setup, and would provide inordinately excessive profits for a third contractor with a still different financial problem.

"(3) War contractors in most cases can protect themselves against loss by escalator clauses and other contract provisions for contingencies. The people can obtain protection in many cases only through some procedure such as renegotiation.

"(4) Experience has shown 'cost-plus' contracts to be worse than worthless in the effort to prevent excessive costs. They strongly tend to increase costs instead of the reverse."

It seems extremely unlikely that any legislation can have more than moderate success in eliminating all profits arising solely out of war or in equalizing the burdens of war. War tax measures appear to have achieved a good deal in the way of raising revenues; experience thus far has indicated that they can do little to eliminate the abnormal profits arising from war. The advocates of the excess-profits tax have no answer to the proposition that it is necessary to have flexibility in working out equitable limitations of war profits, and the excess-profits tax

[153] SEN. REP. No. 944, Pt. 2, 74th Cong., 1st Sess. (1935) 25 *et seq.*, discusses some of the technical difficulties inherent in applying different measures of capital value.

[154] *Hearings before the House Ways and Means Committee on H. R. 2324, H. R. 2698 and H. R. 3015*, 78th Cong., 1st Sess. (September, 1943).

[155] Additional Report of the Senate Special Committee Investigating the National Defense Program pursuant to SEN. RES. 71, 77th Cong., on Renegotiation of War Contracts, SEN. REP. No. 10, Pt. 5, 78th Cong., 1st Sess. (March 30, 1943) 2.

achieves a rigid uniformity which experience has plainly shown is not adequate to achieve reasonable prices of munitions to the Government. The excess-profits tax does achieve some degree of certainty for contractors, but the price of such certainty is the ineffective rigidity which so hampers the Government.

All efforts at war profit limitation involve attempts to achieve as much saving as possible to the Government in the way of making munitions prices reasonable in the light of the speed in procurement required. Such efforts have also sought to preserve the continued efficacy of the profit motive to induce extraordinary war production and industrial effort. So long as the nation's war production is premised on the profit motive, industries engaged in war work will and should make "reasonable" profits, which will presumably exceed the profits of industries not so engaged. All efforts at profit limitation prior to this war have been faced with two major problems—first, the determination of what are "reasonable" profits or prices to the Government, or, stating it obversely, the determination of a proper standard for defining excessive profits, and second, the discovery of effective means to prevent profits from exceeding such standard. No general rules have as yet successfully been laid down for solving these two excessively complicated problems as applied to all cases. "Reasonable" is a rather imprecise word when applied to war profits, as in any other connotation, and attempts to define it meet the problem of using other rather broad and indefinite terms. Reasonable war profits are those which will encourage the contractor to efficient war production and yet will not make the prices of munitions unfair to the Government. Reasonable profits are those which, when judged by the general standards and mores of the day, are acceptable to the majority of the citizens of the nation.

Consider for a moment the difficulties inherent in establishing a standard. War contracts vary widely in substance and form. Airplanes purchased for $100,000,000 can be produced more rapidly than a battleship costing the same amount. Reasonable profits under a contract involving $100,000,000 to be performed within one year with a minimum capital investment may be quite different from reasonable profits to be allowed on a contract requiring the same amount of money but to be completed over a period of three or more years and requiring a larger permanent investment. In determining what profits are excessive, it is also necessary to consider the varying treatments fairly to be accorded contractors whose plant facilities and working capital are supplied by the Government and to contractors supplying plant and working capital in addition to management.

The effect of increased volume and the experience which goes with it must also be studied. It is often difficult to make allowance for such factors in advance. Costs and profits seemingly reasonable at the start of the contract often become unreasonable after volume and experience have increased. Furthermore, it is necessary to consider to what extent the procurement agencies are to offer rewards for increased speed and efficiency. High costs can be more expensive than high profits. While there must be some review or limitation of the amount of the reward for

speed and efficiency, there is no doubt that the force of the profit motive must not be unduly restricted, at least until some equally compelling substitute is found.

Turning to the second part of the problem of devising equitable methods for limiting war profits, and assuming that a standard of reasonable profits has been devised to fit all cases and accurately weigh all relevant factors—an untenable assumption in the light of our past experience—it may be doubted whether a universal rule should be laid down which will require a return to the Government of all profits above that standard. Consideration must always be given to the desirability of offering the contractor a chance of increased profits in return for increased efficiency and production; such increased profits may be very small and continuously diminish. England in the early months of the war collected through excess-profits taxes all profits above a certain standard established for each taxpayer by reference to profits in pre-war years. After a trial, England apparently concluded that the absolute limitation of profits should be modified, and provided for an unconditional return after the war of 20 per cent of the war excess-profits tax. Thus the spur of an ever increasing profit, no matter how small, has been preserved.

The intricacy of our economic organization and the dependence, particularly in time of war, of prime contractors upon subcontractors, raise their own peculiar problems in the establishment and administration of any standard of reasonable profits. The skilled personnel and detailed work required to administer any form of profit limitation have already been touched upon.

The war profit limitation attempts prior to the present war have demonstrated conclusively that there is no categorical answer to the matter of elimination of war profits and prices of munitions. Experience in this war might indicate that there is no reasonably satisfactory answer to be had to the problem so long as we operate with the profit motive as the primary incentive for wartime production. The nation entered World War I entirely unequipped to cope with either the production problems or the economic problems facing it. The nation entered this war far better prepared to meet the incredibly complex production problems incident to the war. Notwithstanding, however, the great amount of effort expended in the 1930's in the investigation and consideration of various methods of wartime profits controls, the country was hardly better equipped to meet the problems of munitions prices and profits on December 7, 1941, than it was on April 6, 1917. This is not to suggest that the exhaustive investigations of war profits during this period did not serve a purpose; indeed, they served a very useful purpose in pointing out the shortcomings of our previous efforts at war profit limitation and lighting up the major problems to be faced in formulating a control over munitions prices. Again, it is possible to suggest that there is no answer to our failure to be prepared to handle this problem efficiently and expeditiously upon the outbreak of war. Having balanced the equities, the nation has concluded that the incentive of the profit motive, with its obvious attendant difficulties as to profit limitations, is to be preferred to a system based upon some other theory, under which perhaps complete control over return upon capital could be established.

RENEGOTIATION AND PROCUREMENT†

WILLIAM L. MARBURY* AND ROBERT R. BOWIE**

The Renegotiation Act[1] is often discussed merely as a more flexible method of recapturing excessive profits from war business. But this conception of the statute, while common among many contractors and government officials, distorts it by over-emphasizing one of its aspects; the truth is that the function of the renegotiation statute is in many respects different from taxation. This article will attempt to show what those differences are and why they are important.[2] To do so will require a rather full consideration of the background and origin of the law and of the conditions which have influenced its administration, but this discussion may hold some interest for its own sake as an example of how the application of a statute is molded by external conditions, practical necessities and the attitudes of those affected.

BACKGROUND OF THE STATUTE

Immediately after our formal entry into war, the tempo of procurement of munitions—already strenuous—became almost frantic. From the highest quarters came mandates to the procuring agencies and the contractors with whom they dealt, to consummate pending negotiations without further delay and to undertake new negotiations before the old were completed. Program followed program with dizzying rapidity until the contracting officers despaired of ever getting contracts placed in time to meet accelerated requirements. Contractors were being asked to produce

† The opinions expressed in this article are those of the authors and are not to be taken as representing official views of the War Department.

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[1] 56 STAT. 245, 41 U. S. C. A. note prec. §1 (Supp. 1942) (Sec. 403 of the Sixth Supplemental National Defense Appropriation Act, 1942, Pub. L. No. 528, 77th Cong., 2d Sess., April 28, 1942, as amended by Pub. L. No. 753, 77th Cong., 2d Sess., October 21, 1942, Pub. L. No. 108, 78th Cong., 1st Sess., July 1, 1943, Pub. L. No. 149, 78th Cong., 1st Sess., July 114, 1943).

[2] At the time this article went to press, further amendments to the Renegotiation Act were contained in the pending Revenue Bill of 1943 (H. R. 3687, 78th Congress, First Session, introduced November 18, 1943). In their present form, these amendments separate renegotiation to recapture excessive profits from repricing for future performance. Since it is impossible to predict whether these or other amendments will ultimately be adopted, this article does not attempt to discuss the effect of these pending amendments. It is believed, however, that they are not likely to affect the basic principles considered in the article. See concluding article in this symposium, by Jules Abels, on the pending proposals.

items new to them or in quantities far beyond their experience. Frequently it was impossible to arrive at any reasonable estimate of production costs. Pricing was a game in which all concerned were blindfolded.[3]

The uncertainty as to costs made the customary fixed-price contract unsatisfactory in many cases. Fearing the consequences of too low an estimate, contractors sought prices high enough to protect themselves against any possible error. While aware of the difficulties, contracting officers were frequently reluctant to agree to prices which were likely to prove grossly excessive in the light of actual production costs. In this situation, in order to avoid prolonged negotiations and delay in production, it was vital to provide in some way for relating the compensation to be paid under the contract to the actual costs experienced in performing it. One obvious method of doing this was the cost-plus-a-fixed-fee basis of contracting, which therefore threatened to become widespread.[4] The principal objection to this form of contract was the absence of incentives to control or reduce costs. Another weighty objection was the amount of auditing and paper work it required to protect the Government's interest.[5] It was, therefore, essential to find some substitute for the fixed-fee contract which would not suffer from its defects.[6]

The problem was submitted to a committee of representatives of the War Production Board, the War Department and the Navy Department and resulted in the preparation of two contract clauses.[7] One, known as the "redetermination clause,"

[3] At the hearings before a subcommittee of the Senate Committee on Appropriations, 77th Cong., 2d Sess., on H. R. 6868 (hereinafter referred to as "H. R. 6868 Senate Hearings"), General Somervell, Commanding General, Services of Supply, War Department, testified, at p. 24, as follows:

"We are asking contractors to produce articles which have never been produced before. We are asking other contractors to produce articles which they have never produced before. We are asking still other contractors, who have produced articles in small quantities, to produce them in vastly larger quantities. The result of all this is that neither the contractors nor the contracting officers can make an accurate forecast of the cost of performance.

"Both parties know that there will be a period of adjustment during which costs will be high. Facilities must be converted, new facilities obtained, new personnel employed and trained to new methods, and new sources of supply developed. How long this adjustment period will last is a matter of uncertainty.

"On the other hand, assuming that the contractor is able to master the problem and to get into production, a time will come when costs will suddenly drop. When this time will come, or how far the drop will extend, it is virtually impossible to foresee. Furthermore, even when costs appear to have reached a definite level, there is no assurance of stability. Change in military strategy may cause changes in priority regulations which will affect the flow of supplies, with the result that costs will rise again. Changes in economic policy may result in increased costs of labor and materials.

"The plain fact of the matter is that in many cases it is impossible to tell, until completion of the contract, whether the contractor suffers a heavy loss, or makes a large profit."

[4] The use of the cost-plus-a-fixed-fee system of contracting (but not the cost-plus-a-percentage-of-cost basis) has been authorized by various statutes in connection with defense and war purchasing. See, *e.g.*, §1(a) of Act of Aug. 7, 1939, 53 STAT. 1239, 5 U. S. C. A. §220(a); §2(a) of the Act of June 28, 1940, 54 STAT. 680, 41 U. S. C. A. note preceding first section in title; §1(a) of Act of July 2, 1940, 54 STAT. 714, 41 U. S. C. A. note preceding first section in title; and see note 6, *infra*.

[5] See letter of U. S. Comptroller General to Hon. Louis Ludlow, 89 Cong. Rec., Jan. 14, 1943, p. A-127. Compare letter from Under Secretary of War Patterson to Hon. John W. McCormack, June 9, 1941. 87 CONG. REC. 4909 (1941).

[6] With certain specified exceptions, all restrictions on methods of contracting and types of contracts and contract provisions were removed by Title II of the First War Powers Act, 1941, Act of Dec. 18, 1941, 55 STAT. 838; 50 U. S. C. A. App. §611; and Exec. Order No. 9001, Dec. 27, 1941, 6 FED. REG. 6787. See 40 OP. ATTY. GEN. No. 53 (Aug. 29, 1942).

[7] These clauses were first authorized for use in War Department contracts by P. B. Gen. Directive No. 31 (March 13, 1942).

was designed to permit automatic adjustment downward in price on the basis of actual cost experience during a "test run" early in the performance of the contract.[8] The other contract provision, originally known as the "renegotiation clause," was designed to permit adjustment of the price either upward or downward in the light of actual cost experience after part performance, as soon as reasonably reliable cost estimates were feasible.[9] It was recognized as essential that the time for adjustment in each case should be sufficiently early in the life of the contract to retain incentives. So used, these clauses combined the main advantages of both the fixed-price and the fixed-fee contracts without their disadvantages. Under them the letting and performing of contracts were not delayed by haggling over uncertain estimates and prices; and ultimate prices were kept in line with cost experience without sacrificing the incentives of the contractor to reduce costs, at least during performance after the price was adjusted.

While the attention of the procuring agencies was thus concentrated on the development of these new forms, very large profits resulting from some of the early fixed-price contracts, under which production had already gotten under way, began to come to light. Since these profits usually reflected ignorance of costs when the contracts were made, the War Department promptly started voluntary negotiations with such contractors to adjust the contract prices to reasonable levels consistent with actual costs; and generally contractors were willing to reduce prices to those which would have been agreed to originally if similar cost experience and data had been available. In April, 1942, the War Department set up a Board to handle such adjustments.[10]

ADOPTION OF THE STATUTE

However, these measures taken by the War Department to deal with such inflated profits were not permitted to develop along normal lines. As a result of the investigations culminating in the report of the Special Committee Investigating the Munitions Industry,[11] published in 1935, the determination had become widespread to prevent

[8] Briefly, the original redetermination clause required the contractor to state in the contract the cost estimates on which the contract price was based and, after performance had begun, to submit data on the cost of performance during the "preliminary run" while production was getting under way and during a test run after production became more typical. If the total costs for the "preliminary run" and for the remainder of the contract, as indicated by the test run, were less than the estimated costs on which the price was based, the price was adjusted accordingly. The revised form of this clause, authorized by the War Department Procurement Regulations for use where costs cannot be reliably estimated at the time the contract is made, is set forth in the Appendix to this article.

[9] This renegotiation clause required the contractor to state in the contract the cost estimates on which the price was based and to submit cost data for performance during a trial run at the beginning of the contract. On the basis of this cost experience, the parties were to renegotiate the contract price by agreement. A revised form of this clause, now called "Revision of Price by Negotiation" to distinguish it from the statutory renegotiation article, is currently authorized by the War Department Procurement Regulations for use where costs cannot be reliably estimated at the time the contract is made. It is set forth in the Appendix to this article.

[10] The Price Adjustment Board was formally created by Memorandum dated April 25, 1942, from the Commanding General, Services of Supply of the War Department. After the passage of §403, the authority of the Board was extended by Memorandum of June 30, 1942, to make the Board the agency to administer renegotiation under the statute.

[11] SEN. REP. No. 944, 73d Cong., 2d Sess. (1934).

a recurrence of the profiteering that had marked the conduct of the first World War. Numerous proposals had been advanced to accomplish this purpose and the desirability of legislation in some form for the limitation of profits was generally accepted. Inevitably, the publication during the early months of 1942 of reports of tremendous profits generated a strong public pressure to devise an effective method of profit control. Promptly reacting to this sentiment, during the early part of last year a number of Congressional committees began to examine into this question.[12] Particular attention was paid to the possibility of special taxation on war profits and to the revival of a profit limitation in the manner of the Vinson-Trammel Act of 1934.[13] That legislation had required repayment to the Treasury of all profits in excess of a fixed percentage of the cost of production. After six years during which recovery had been hardly commensurate with the administrative expenses involved,[14] the Vinson-Trammel Act had been suspended by the Second Revenue Act of 1940.[15] Its revival as a means of controlling wartime profits was strongly opposed by industry and by government agencies who saw in the rigidity of its application and its requirement of cost accounting, grave threats to the war production program.[16]

While committees were thus investigating the whole subject of war profits, there was abruptly introduced on the floor of the House of Representatives an amendment to the Sixth Supplemental National Defense Appropriation Act, 1942.[17] This amendment would have forbidden the payment from appropriated funds of the final payment due under any contract, past or future, until the contractor presented a certificate of cost and an agreement "for renegotiation and reimbursement" satisfactory to the Secretary of War or of the Navy, as the case might be.[18] It was apparent that this method of control was inspired by the renegotiation clause already discussed and this impression has been confirmed by Mr. Case of South Dakota who was the author of the amendment.[19] Although called renegotiation, what Mr. Case

[12] See *e.g.*, H. R. 6790, 77th Cong., 2d Sess. (1942), and the hearings thereon before the House Committee on Naval Affairs.

[13] Act of March 27, 1934, 48 STAT. 504, 34 U. S. C. A. §496, as amended by Act of June 25, 1936, 49 STAT. 1926, 34 U. S. C. A. §496; Act of April 3, 1939, §14, 53 STAT. 560, 10 U. S. C. A. §§311, 312, 34 *id.* §496; Act of June 28, 1940, 54 STAT. 676, 41 U. S. C. A. note preceding first section in title; and Act of Sept. 9, 1940, 54 STAT. 883, 41 U. S. C. A. note preceding first section in title.

[14] The total amount assessed under the Act up to Sept. 30, 1942, was approximately $7,500,000. See *Hearings before the subcommittee of the Senate Committee on Finance on Renegotiation of Contracts*, Sept. 29-30, 1942, 77th Cong., 2d Sess., pp. 94-98.

[15] See Act of Oct. 8, 1940, 54 STAT. 1003, 34 U. S. C. A. §496a, 46 *id.* §1155a.

[16] See testimony of Under Secretary Patterson and Mr. Donald M. Nelson, Chairman of the War Production Board, at the *Hearings before the House Committee on Naval Affairs on H. R.* 6790, 77th Cong., 2d Sess. (1942) 2473-2475, 2577-2578.

[17] 88 Cong. Rec., March 28, 1942, p. 3230.

[18] The exact words of the proposed amendment were as follows: "Sec. 402-A. No part of any appropriation contained in this act shall be available to pay that portion of a contract for construction of any character and/or procurement of material and supplies for either the Military or Naval Establishments designated as 'final payment' until the contractor shall have filed with the procuring agency a certificate of costs and an agreement for renegotiation and reimbursement satisfactory to the Secretary of War or the Secretary of the Navy, as the case may be."

[19] See 88 Cong. Rec., March 23, 1942, p. 3228. Another factor prompting the proposal was the decision in the U. S. v. Bethlehem Steel Corporation, 315 U. S. 289 (1942).

proposed was apparently that the profit to be paid any contractor should be determined by the Government after performance and in the light of costs.

Inasmuch as this proposal involved administrative action, it was subject to a point of order which was promptly made.[20] Its author thereupon offered an amendment which substituted for the discretion of the contracting officer an arbitrary percentage profit limitation, but of what did not appear.[21] As thus modified his amendment was adopted without debate and by an overwhelming vote.[22]

The procurement agencies immediately protested. Hearings were held before the Subcommittee on Appropriations of the United States Senate at which their objections to the Case amendment were forcibly stated.[23] The attention of the Committee was called to existing administrative practices designed to prevent excessive profits. The so-called "renegotiation" and "redetermination" clauses were described and their use in preventing excessive profits was explained. Reference was also made to the fact that an administrative agency had just been created within the War Department to bring about voluntary reductions in contract prices where a study of the overall profits of a contractor indicated that he was being paid too much for his products. The Committee was told of one example where a voluntary reduction of contract price had been agreed upon which was expected to save the Government $40,000,000.

As the hearing progressed it became apparent that some sort of legislation to control profits was inevitable. At the request of the Chairman of the Committee the procurement agencies drafted a substitute for the Case amendment. This substitute read as follows:

1. The Secretary of War is directed to insert in any contract hereafter made by the War Department, which, in his judgment, may result in an excessive profit to the contractor, a provision for the renegotiation of the contract price at a period when the profits can be determined with reasonable certainty.

2. The Secretary of War is directed, whenever in his opinion excessive profits have been realized, or are likely to be realized, from any contract with the War Department, to require such contractor to renegotiate the contract price. This provision shall be applicable to all contracts hereafter made and to all contracts heretofore made, whether or not such contracts contain a renegotiation clause, provided that final payment has not already been made pursuant to such contract.

3. In renegotiating a contract price the Secretary of War shall not make allowance for any salaries, bonuses, or other compensation paid by the contractor to its officers or employees, in excess of a reasonable amount, nor shall he make allowance for any excessive reserves set up by the contractor, and the Secretary of War shall freely use the powers of audit conferred upon him by existing law for the purpose of ascertaining whether such

[20] 88 Cong. Rec., March 28, 1942, p. 3230.

[21] *Ibid.* The text of the substitute amendment was as follows: "Sec. 402-A. No part of any appropriation contained in this act shall be available to pay that portion of a contract for construction of any character and/or procurement of material and supplies for either the Military or Naval Establishments designated as 'final payment' to any contractor who fails to file with the procuring agency a certificate of cost and an agreement for renegotiation of contract and reimbursement of profits in excess of 6 percent."

[22] The record shows that the vote stood—ayes 70, noes 8. *Id.* at 3231.

[23] *H. R. 6868 Senate Hearings*, 22-30, 35-49, 83-92, 211.

unreasonable compensation has been or is being paid, or whether such excessive reserves have been set up.

4. In addition to the powers conferred by existing law, the Secretary of War shall have the right to demand of any contractor who holds uncompleted contracts with the United States for the production of war materials in the aggregate amount of $500,000 or more statements of actual costs of production and such other financial statements, at such times and in such form and detail as the Secretary of War may require.

5. The authority and discretion herein conferred upon the Secretary of War may be by him delegated to such individuals or agencies in the War Department as he may designate and he may authorize such individuals to make further delegations of such authority and discretion.

6. The foregoing provisions shall be applicable to the Secretary of the Navy in the case of contracts with the Navy Department, and to the Chairman of the Maritime Commission in case of contracts with that Commission. The powers conferred by paragraph 4 above shall be exercised by the War Department, the Navy Department, or the Maritime Commission, whichever holds the largest aggregate amount of uncompleted contracts for the production of war materials.[24]

While this proposal bore the marks of hasty preparation and was somewhat lacking in inner consistency, it was reasonably clear on the following crucial points:

(a) Except where otherwise provided by the insertion in the contract of a specific provision, any renegotiation was apparently intended to apply primarily to amounts remaining unpaid under the contract.

(b) The insertion of the renegotiation clause in a contract was left wholly discretionary with the head of the procuring agency.

(c) Any renegotiation either under a renegotiation clause or otherwise, was to be a genuine renegotiation without power in the Government to compel adjustment.

(d) Any renegotiation was to be conducted during the life of the contract.

But this proposal of the Departments was radically altered by Congress, and as finally enacted, Section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942, differed from the proposal on all of these points.

(a) It provided for the recapture of profits already paid to the contractor and found to be excessive as a result of renegotiation whether conducted under a contract provision or otherwise.

(b) It made mandatory the insertion in any contract in excess of $100,000 of a clause calling for renegotiation of the contract price.

(c) It contained language which has been widely construed to confer upon the Government the power to compel adjustment where the agreement of the contractor cannot be obtained.[25]

[24] *Id.* at 84.

[25] Subsection 403(a) containing the definitions, provides that "the terms 'renegotiate' and 'renegotiation' include the refixing by the Secretary of the Department of the contract price." See the discussion in *Renegotiation of War Contracts*, NAT. ASSN. MFRS., LAW DEP'T BULL. (Aug. 26, 1942) 4. Compare the statements on this question in the debates in the Senate. 88 Cong. Rec., April 23, 1942, at pp. 3763-3771 and 3773-3776.

(d) It provided that renegotiation, whether effected under the contract provision or otherwise, might take place at any time up until three years after the termination of the war.

EARLY ADMINISTRATION OF THE STATUTE

The full significance of the changes that Congress had made in the procurement agencies' proposal soon became apparent. Up until April, 1942, the renegotiation of contract prices was an integral part of the procurement process. Whether or not renegotiation was conducted under a so-called "renegotiation" clause, the objective was the same—the adjustment of the contract price to a figure which would have been regarded as reasonable at the time of the original negotiation, had the facts been available to the parties. Furthermore, such a negotiation was in every instance undertaken during the lifetime of the contract at a time when the incentives of a fixed-price method of contracting could still have sufficient scope within which to operate. It is true that under the "renegotiation" clause, price adjustments might be retroactive to the beginning of the contract. In almost no case, however, was recapture of profits the primary result, although in some cases payments for units thereafter delivered might be greatly reduced as a result of excessive payments previously made.

Renegotiation as conducted under the statute, on the other hand, took on a different aspect. This was principally due to the fact that renegotiation was applicable to all contracts and subcontracts and could be required after the contract affected had been completed. As generally construed by contractors and their counsel, the statute rendered contractors liable, until three years after the war, to be called upon to refund such part of any profits earned by them on their war contracts or subcontracts as the head of the procuring agency or his delegates might see fit to require, and this liability would continue until any contract subject to renegotiation had been finally dealt with. This situation presented a serious dilemma. The natural hesitancy of contractors to make contracts which would subject them to a liability undetermined in amount and indefinite in duration threatened to impede the procurement program. Since it was obviously impossible to examine and renegotiate individually the prices of all contracts and subcontracts subject to the statute within any reasonable period, some other means for disposing of this potential liability with reasonable promptness had to be found.

To avoid this impasse, there was developed the method of "overall" renegotiation. Under this procedure the contractor's profits on its entire war business for a specified fiscal period were examined in order to reach an agreement for eliminating excessive profits on the contracts as a group, and an agreement made covering the period involved.[26] In addition to giving contractors clearance with reasonable promptness, this method had several other important advantages. By dealing with all contracts together, cost accounting and the allocation of costs were reduced to a minimum, and time was saved for both contractors and the Government. Furthermore, this method

[26] A full statement of the detailed procedures will be found in "Principles, Policies and Procedures to be Followed in Renegotiation" published by the War Department Price Adjustment Board.

permitted contractors to offset losses on any war contracts against profits from other war contracts during the same period.

By its very nature, however, overall renegotiation tended more and more toward recapture of past profits rather than refixing of prices for future periods. Since it was based on the fiscal year of the contractor it was more convenient to postpone renegotiation until the usual financial statements for the period had been prepared. In addition, because of the difficulty of forecasting profits before the end of the fiscal period, contractors preferred to postpone a settlement until their profits were known. For the same reason, government officials, especially in the beginning, hesitated to give a clearance to the contractor for a future period on the basis of predictions. Administered in this way, the law was in effect a tax of 100% on all profits from war business, which the procuring agencies regarded as excessive, and was wholly different from the procedure for revising contract prices after part performance, which had inspired the statutory scheme. In fact, when contracting officers desired to provide for such individual price revision, they asked permission to use the old form of contract renegotiation clause, in addition to the statutory provision. Thus, many contracts now exhibit the paradox of two renegotiation clauses substantially similar in wording, but wholly different in their practical operation. This curious practice illustrates dramatically the extent to which statutory renegotiation on an overall basis had departed from the actual adjustment of contract prices, and indicates that renegotiation under Section 403 as practiced during the early months of its operation, was merely a discretionary excess profits tax of 100%.

Before this interpretation of the statute had become settled, however, other powerful forces were in motion to shift the emphasis in its administration. The first of these forces was the drive to prevent inflation. When in the spring of last year the Office of Price Administration expanded its price regulations to cover practically the entire economy by issuing its General Maximum Price Regulation[27] and its machinery regulation—MPR No. 136[28]—a serious problem was presented in connection with military procurement. While a great many of the articles procured by the Army were already under price regulation, its extension to the strictly military items which were subject to frequent changes would have required elaborate formulas for flexible regulation. In an effort to avoid the divided authority and complexity which would have resulted from the establishment of such price control by the Office of Price Administration, the procuring agencies were obliged to develop other means which would accomplish the desired result of controlling inflation in this field.[29] Mere recapture of past profits by renegotiation under Section 403 did not serve this

[27] Issued April 28, 1942, 7 FED. REG. 3153, effective May 11, 1942. Effective date as to sales or deliveries to or contracts with the War Department postponed to July 1, 1942, by Supplementary Regulation No. 2, issued May 9, 1942, *id.* 3489. Combat and certain other military items exempted by Supplementary Regulation No. 4, issued May 13, 1942, *id.* 3724.

[28] Issued April 28, 1942, 7 FED. REG. 3198. Originally effective May 18, 1942, postponed to June 1, 1942, by Amendment No. 2, May 14, 1942, *id.* 3723, and to July 1, 1942, by Amendment No. 3, May 29, 1942, *id.* 4176. Revised and re-issued June 30, 1942, *id.* 5047, to become effective July 22, 1942.

[29] OPA SECOND QUARTERLY REPORT (1942) 39-45.

purpose. While this would stop the flow of dividends to stockholders, it operated too late to protect the economy from inflationary expenditures for manpower and materials. In fact, administration of the statute as a taxing measure confined to the recapture of profits earned in the preceding fiscal year may tend to stimulate inflation by taking the pressure off the procurement officers to negotiate a proper price at the inception of the contract and by lessening the incentive of the contractor to reduce his costs. What was needed was more effective control of prices for the future, to prevent excessive profits from accruing at all.

The second of these influences was created by the shortages of critical materials and manpower which were then beginning to become serious. To maintain the greatly accelerated production of war materials, and make most effective use of our available resources, it was recognized that all producers must operate at their highest efficiency with the minimum waste of labor and materials. Since economic pressure on price has been the traditional way of evoking such efforts to reduce costs, it was natural that attention should turn toward closer pricing as a means to conserve labor, materials and facilities.[30] When that objective had become crystallized, the procuring agencies gradually became aware that the policies and methods followed for profit control would largely determine the success or failure of the program. Real incentives on the part of contractors to reduce their costs in order to increase their profits can hardly be maintained if all the profits will be taken from them on renegotiation. On renegotiation to recapture past profits, this tendency can be overcome to some extent by allowing a higher rate of profit for more efficient producers,[31] but this is only a partial solution to the problem. Accordingly, some other method was needed.

While these pressures for narrowing the field of recapture as far as possible and for relying more heavily on purchase and price control were developing, the statute was under direct attack from another quarter. Representatives of industry objected that renegotiation for the recapture of past profits was merely a delegation without standards of the power to tax profits from war business and was an unjustified departure from established principles of taxation. Accepting this view, prominent members of the Senate Committee on Finance urged the outright repeal of the statute.[32]

[30] See note 45, *infra*.

[31] See WAR DEPARTMENT MANUAL FOR RENEGOTIATION, pars. 421, 422.

[32] See *Hearings before the Senate Committee on Finance on the Revenue Act of 1942*, 77th Cong., 2nd Sess., Vol. I, p. 981. The following took place:

"*The Chairman.* (Senator George) I think there is a great deal in what you say, and ultimately the Congress will repeal that renegotiation-of-contract provision, because it has been found that it will be utterly unworkable.

"*Senator Taft.* Mr. Chairman, I think it ought to be repealed in this bill.

"*The Chairman.* I think in doing that there should be an over-all limitation on profits on war contracts, both prime contracts and subcontracts, over the whole period, so that there could be no unconscionable profiteering out of the war.

"*Mr. Fernald.* That would be profits after what has already been taken by taxes.

"*The Chairman.* Yes; an over-all limitation on the war profits directly. I think you can very well leave the excess-profits tax to operate on all non-war profits anyway.

"*Mr. Fernald.* I think you have gotten it to operate pretty well on the war profits as well, sir. I am not very much disturbed about that.

The result of all these factors was to bring back to the surface the conception of renegotiation as a method of price control—a conception which had to a large extent been submerged in the actual administration of the statute. At the same time there were serious objections to an abandonment of the procedure which had been developed under the statute. It was forcefully argued that price adjustment without recapture might fail to eliminate excessive profits in some cases and there was always the strong probability that if recapture were completely abandoned and excessive profits did result, Congress would adopt a flat profit limitation which would create serious obstacles to procurement. How to develop the statutory process as an effective control of inflation, and as a means of saving manpower and materials, without creating once again the conditions which had led to its original enactment, was the problem.

AMENDMENT OF THE STATUTE

The matter was brought to a head when the Chairman of the Senate Committee on Finance proposed to substitute for renegotiation an entirely new law imposing a flat limitation on profits after taxes.[33] In consequence hearings were held at which the entire position of the statute was carefully analyzed.[34] The War Department, the Navy Department, the Treasury Department and others gave their views on the function and administration of the statute. While recognizing the shortcomings of renegotiation for recapture, the Departments repeated with emphasis the objections to the substitution of a flat profit limitation which they had originally voiced when the statute was first under consideration. Stressing the importance of controlling costs as well as profits and of maintaining incentives for efficiency,[35] they pointed out the relation of the renegotiation statute to these objectives, and the need for increased emphasis on this aspect of the problem. To facilitate the administration of the statute, especially as a means of price control, the Departments offered a number of amendments. Of these changes, some were merely intended to clarify the statute and to correct obvious deficiencies, but others were designed to permit a shift from recapture to price control in the administration of the statute.[36] These proposals for revising the statute were adopted by Congress as Section 801 of the Revenue Act of 1942.[36a]

"The Chairman. It is not the renegotiation, it is the uncertainty involved, and the long time in which those renegotiations will be going on, and the constant change of personnel at the head of divisions working it out, leads to so many complications until certainly at some time during this war, if the war goes on for another year or two, we are going to have to deal with that question. It is very proper to say it should be dealt with."

The fact that the pending Revenue Act of 1942 included the new Excess Profits Tax led many who viewed renegotiation primarily as a tax measure to feel that it was no longer needed and should therefore be repealed.

[33] See *Hearings before the Senate Committee on Finance on Section 403 of Public Law 528*, 77th Cong., 2d Sess., Sept. 22-23, 1942, p. 60.

[34] *Ibid.*; and *Hearings before the subcommittee of the Senate Committee on Finance on Section 403 of Public Law No. 528*, 77th Cong., 2d Sess., Sept. 29 and 30, 1942.

[35] *Id.* at 7, 19-20, 92-93.

[36] *Id.* at 51-53, 147-149.

[36a] Act of Oct. 21, 1942, Pub. L. No. 753, 77th Cong., 2d Sess., 56 STAT. 798.

With the amendments designed to perfect the statute as a means of recapture of excessive profits we are not here concerned, but other changes are significant for the present study. One of these conferred upon the Secretary the discretionary power to exempt from renegotiation any contract or subcontract under which the profits can be determined with reasonable certainty when the contract price is established.[37] The full use of this power would permit the Secretary to exclude from renegotiation large numbers of contracts and subcontracts under which prices are known to be fair when the contract is made, and thereby to ease the administrative burden. Similar in its effect was the exemption of contractors and subcontractors whose total war business did not exceed $100,000 for their fiscal year.[38] Another equally important provision is the discretionary power to exempt from some or all of the provisions of Section 403, as amended, the performance under any contract or subcontract during a specified period or periods and to provide that the contract price in effect shall not be subject to renegotiation if, in the opinion of the Secretary, the provisions of the contract or subcontract are otherwise adequate to prevent excessive profits.[39] For example, where the contract contains other provisions for price adjustment or profit limitation which the Secretary considers adequate, he may exempt it from statutory renegotiation and from profit recapture. A further amendment to the statute expressly authorizes the Departments upon renegotiation to grant clearances for future as well as past periods, thereby making it possible to exempt some or all of the contracts or subcontracts of a contractor for a specified future period.[40] Still another amendment authorizes the contract article for renegotiation to specify the time within which renegotiation will be held.[41] This would allow the Secretary to limit renegotiation to the life of the contract if he so desires.

These amendments provide the means for a return to the prestatutory conception of renegotiation. Without requiring abandonment of retroactive recapture of excessive profits, they afford an opportunity for a shift of emphasis to prospective pricing. If this opportunity is fully exploited, renegotiation can again become a more

[37] Section 403(i)(2)(ii) enacted by §801 of the Revenue Act of 1942; §403(i)(2) reads as follows:

"(2) The Secretary of a Department is authorized, in his discretion, to exempt from some or all of the provisions of this section—

(i) any contract or subcontract to be performed outside of the territorial limits of the continental United States or in Alaska;

(ii) any contracts or subcontracts under which, in the opinion of the Secretary, the profits can be determined with reasonable certainty when the contract price is established, such as certain classes of agreements for personal services, for the purchase of real property, perishable goods, or commodities the minimum price for the sale of which has been fixed by a public regulatory body, of leases and license agreements, and of agreements where the period of performance under such contract or subcontract will not be in excess of thirty days; and

(iii) a portion of any contract or subcontract or performance thereunder during a specified period or periods, if in the opinion of the Secretary, the provisions of the contract are otherwise adequate to prevent excessive profits.

"The Secretary may so exempt contracts and subcontracts both individually and by general classes or types."

[38] Subsection (c)(6) of §403, as amended by Rev. Act of 1942, §801.

[39] §403(b) and §403(i)(2)(iii) enacted by Rev. Act of 1942, §201. See note 37, *supra*.

[40] §403(c)(4) enacted by Rev. Act of 1942, §801.

[41] §403(b), as amended by Rev. Act of 1942, §801.

integral part of the procurement process and the need for recapture will be greatly reduced. The legislative history of the amendments makes it clear that Congress recognized the importance of using renegotiation as an instrument of price and cost control, and intended to provide tools for making the transition to that basis as rapidly as conditions would allow.[42]

With the need for developing a closer relation between profit control and the maintenance of incentives for efficiency and cost control thus accepted, it remains to be seen how far the amendments included in the Revenue Act of 1942 will be used for this purpose. The limited cost data and experience available for many types of war materials, and the wide variations among producers all create difficulties which make for adherence to the method of recapture. However, the War Department has made the first effort at general use of the powers granted by the amendments. On January 2, 1943, it authorized the use in War Department contracts of two new clauses providing for periodic price adjustment with provision for exemptions from renegotiation.[43] Both of these articles divide performance under the contract into specified periods of three to six months for the purpose of adjusting the contract price at regular intervals. Under the first form the contract price originally fixed for the first period of performance is exempt from statutory renegotiation. At the end of that period the contractor submits cost data for the preceding period and cost and price estimates for the next period, and the contracting officer and the contractor negotiate to fix a price for the succeeding period under the contract. If the contracting officer is satisfied that the cost data are reliable and that the contract price fixed for the next period is fair to the Government, he may exempt the price from renegotiation. The same procedure is followed at the end of each succeeding period under the contract except the last. The second form of article is designed for cases where cost information is not sufficient at the beginning of the contract to fix a firm price. Under this form, the price for the first period is adjusted at the end of that period and appropriate credit or refund made; otherwise this article is similar to the first form.

These clauses combine various features designed to obtain close prices while retaining incentives for efficiency.[44] Since the periods for which prices are fixed are relatively short, uncertainty and the risk of future changes in conditions are reduced and the need for allowances for contingencies should be correspondingly decreased. At the end of each period, prices for the next period can be fixed on the basis of

[42] The relation between profit and cost control was strongly re-emphasized by the President in his 1943 Budget Message in the following words:

"The procurement program must achieve maximum production with minimum waste and with the speed essential in time of war. This is the controlling objective not only for the original negotiation of contracts but also for the renegotiation required by law. The law provides for the prevention or recapture of excessive profits, thus supplementing and reinforcing the objectives of the excess-profits tax. *I believe that control of the costs of production is of equal importance.*

"The proper negotiation and renegotiation of contracts must strive to reconcile the avoidance of excessive profits, with the maintenance of incentives to economical management." (Italics added).

[43] Memorandum No. S-5-1-43, Jan. 2, 1943, War Dep't, Services of Supply, now included in War Dep't Procurement Regulations as pars. 360.1 and 360.2 of P.R. No. 3 and Section IV of Procurement Reg. No. 12. One of these forms is set forth in the Appendix to this article.

[44] *Ibid.*

recent experience, current conditions and more accurate forecasts. If a firm price exempt from statutory renegotiation is granted, the contractor is enabled to increase his profit by managerial skill, improved methods and efficiency in operation. Finally if costs are reduced in one period through efficiency, then when the prices are adjusted for the succeeding period, the Government will benefit from the reduced costs in the form of lower prices but the contractor will enjoy a higher profit margin.

Despite these advantages the clauses are not a complete solution and have significant drawbacks. Their successful operation requires considerable production experience and reliable cost data to provide the basis for negotiations at the end of each period. They can therefore be used only if the contractor has an adequate cost accounting system. Again they are suitable only for larger contracts where the time spent in preparing the necessary cost information and in negotiating at the specified intervals will not be out of proportion to the amounts involved.

Nevertheless, these clauses are a beginning in the direction of closer price control to prevent the necessity for recapture of past profits. While the extension of this approach will depend on knowledge gained in the use and operation of these articles, on accumulation of production and cost information, and on improved techniques for its use in contract negotiation, the experience of our enemies as well as our allies in waging total war clearly teaches that closer pricing must ultimately be relied on in the interest of higher efficiency and lower costs.[45]

[45] See for discussion of this foreign experience, 7 FOREIGN COMMERCE WEEKLY (U. S. Dep't of Commerce) No. 4, May 2, 1942, pp. 6-7; Withrow, *The Control of War Profits in the United States and Canada* (1942) 91 U. OF PA. L. REV. 194; FOURTH REPORT FROM THE COMMITTEE ON NATIONAL EXPENDITURES, (Great Britain, 1940-1941); FIRST REPORT FROM THE COMMITTEE OF PUBLIC ACCOUNTS (Great Britain, July 21, 1942). The British policy is well stated in a memorandum prepared by the (British) Treasury on the "Excess Profits Tax and Contract Policy," and printed as an Appendix to the FIRST REPORT FROM THE COMMITTEE OF PUBLIC ACCOUNTS, *supra*. Pertinent excerpts are as follows:

"2. In the course of the present inquiry into the prices, and outcome, of certain fixed price contracts, the suggestion has been made by certain of the contractors who have been examined by the Committee that the emergence of a high profit from war contracts is of no advantage to the contractor and does not matter to the State, because after deduction of taxation the contractor is left with a small margin of profit only. The suggestion has also been made that for the same reason the contractor has no incentive to aim at unreasonably high prices, since the profit emerging from such prices would go back to the State in taxation.

"3. There is also an implication arising from these suggestions that the investigation of costs for the purpose of arriving at contract prices (whether fixed price or not) is an unnecessary expenditure of effort. . . .

"11. But the matter is far from being solely one of profit margins. The aim of the State in dispensing the taxpayers' money is to obtain the stores which it requires at the lowest reasonable price.

"12. The best method of securing this end is to give the contractor an incentive to produce at low cost; and the best form of contract for this purpose is the fixed price contract provided that there are sufficient data upon which to assess a reasonable fixed price. If, for any reason, a fixed price contract is not feasible, recourse must be had to some form of costed contract. Though it is more difficult in this case, to provide an incentive to efficient and low cost production, a costed contract can prevent the inclusion in costs of expenditure which the Department is in a position to disallow (e. g. extravagant remuneration to directors, loading of price with overheads irrelevant to the production undertaken for the Government, or wages beyond a recognized level). But more than this, cost investigation may well reveal facts which show that uneconomic methods of production are being practised, and these can be followed up by the Department, with a view to a suitable remedy.

"13. If, however, the price of stores supplied to the Government were left uncontrolled, except for the automatic operation of E. P. T., there would be no effective deterrent to unwarranted rises in cost of whatever kind. The machinery of the Inland Revenue is not intended, nor is it adapted in the same way

In recognition of this, the objective of closer pricing is receiving increasing emphasis in the actual administration of renegotiation. In determining excessive profits for a past period, the pricing policies and records of the contractor during the period are carefully considered in order to reward the fixing of sound prices and the elimination of undue reserves against contingencies in the first instance. Since large loadings in original prices remove most of the risks in performance of the contract, the contractor is entitled to a smaller rate of profit than one who makes close prices and takes the risk of possible losses.[46] Directly related is the policy of requiring price reductions on future deliveries as a part of renegotiation.[47] Such price adjustments are now receiving more and more attention in renegotiation and presumably this trend will increase as the renegotiating agencies become more current in their work.

By attempting to fix close prices in the first instance and eliminating large reserves or loadings for contingencies, and by keeping and making available adequate cost records to provide the basis for sound negotiation, industry can speed this trend and help to substitute well-negotiated original prices for retroactive renegotiation, and to obtain the benefits to Government and industry of normal incentives in the reduction of costs.

APPENDIX

WAR DEPARTMENT PRICE ADJUSTMENT CONTRACT ARTICLES

1. *Redetermination:*

Article —. Redetermination of price by formula.

(a) *Agreement to redetermine price.* The Government and the Contractor recognize that the costs of performing this contract cannot be accurately estimated at the time of its execution, and that the price fixed in Article — may therefore be too high. They therefore agree that the contract price fixed in Article — shall be redetermined in accordance with this Article on the basis of the actual experience of the Contractor in performing part of the contract. They agree that the cost of producing the first —% of the items called for hereunder (hereinafter called the "preliminary run") will not necessarily be typical for the remainder of the contract. The cost of producing the next —% (hereinafter called the "test run") shall therefore be used as the general basis for the redetermination of price.

(b) *Estimate of costs.* The Contractor represents that the contract price fixed in Article — is based on a total estimated cost of $....., itemized as follows:[1]

A. Factory Cost
   1. Direct materials.
   2. Direct productive labor.
   3. Direct engineering labor.
   4. Miscellaneous direct factory charges.
   5. Indirect factory expenses[2] (State basis of allocation).

   Total Factory Cost

B. Other manufacturing cost.

C. Miscellaneous direct expenses.

as the machinery of the Contracting Departments, to analyze costs of production and check unnecessary expenditure; nor could it reveal, as investigation by Contracting Departments can reveal, the existence of uneconomic or wasteful methods of production."

[46] WAR DEPARTMENT MANUAL FOR RENEGOTIATION, pars. 423, 426.3.

[47] *Ibid.*, pars. 440 to 446.

[1] This breakdown may be altered to suit particular circumstances. Any reserves for contingencies should be stated separately and clearly identified.

[2] State separately the estimated amount of each of the following items included:
(a) Normal depreciation.
(b) Special amortization.

D. Indirect engineering expenses.
E. Expenses of distribution, servicing and administration.
F. Guarantee expenses.

(c) *Cost statements.*

(1) Within . . . days after the completion of the production of the "test run" the Contractor shall submit to the Contracting Officer the following data:

(i) Separate statements showing the costs of producing the "preliminary run" and the "test run" itemized in the same way as the estimated cost stated in section (b) above;

(ii) Estimates of the cost of producing the items to be delivered during the remainder of the contract based upon the previous cost experience of the Contractor and upon all other relevant factors; and

(iii) Proposed revised prices under the contract.

(2) The Contractor will maintain books, records and accounts so as to reflect accurately and segregate clearly the costs of performing this contract during the "preliminary run" and "test run." For this purpose the Contractor may follow the cost accounting system regularly used by it, if the Contracting Officer finds it is adequate and in accordance with sound accounting practice. The statements showing costs experienced by the Contractor under this contract shall be based upon such books, records and accounts and shall be certified as correct by two officers of the Contractor or by an independent public accountant. The Contractor shall submit his books, records and accounts to such examination and audit as the Contracting Officer may request.

(d) *Method of redetermination.*

(1) Upon the filing of the data required by Section (c) hereof, the Contracting Officer and the Contractor shall determine the costs of producing the "preliminary run" and the "test run" and the cost of producing the remainder of the items called for by the contract as indicated by the cost of production of the "test run" and the cost estimate submitted by the Contractor under Section (c). Any disagreement as to the experienced costs or estimated costs shall be subject to Article — (Disputes).

(2) If the cost of producing the "preliminary run" and the "test run" plus the cost of production of the remainder of the items called for by the contract as determined under subsection (1) above, is less than the total estimated cost stated in section (b), the total price to be paid pursuant to Article — shall be reduced by the amount of the difference. The redetermined price shall be evidenced by a supplemental agreement.

(e) *Payment.* Pending the redetermination of the contract price hereunder the Government shall pay for all items delivered hereunder at the price fixed in Article —. Upon the redetermination of the price hereunder the Contractor shall apply as a credit against payment for subsequent deliveries or shall repay to the Government, as the Contracting Officer may direct, an amount equal to the difference between the price paid on all items theretofore delivered and the redetermined price for such items; and the Government shall pay for all items thereafter delivered the redetermined price minus any such credit. If, before the price is redetermined hereunder, any amount paid under this contract has been included in any renegotiation agreement made under Section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942, as amended, no refund or credit shall be required hereunder with respect to that amount.

(f) *Renegotiation.* Any redetermination of the contract price made under this Article is without prejudice to the determination of any excessive profits of the Contractor upon subsequent renegotiation under Section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942, as amended, or the contract article inserted herein pursuant to the Act.

2. *Revision by Negotiation:*

Article —. Revision of entire price by negotiation.

(a) *Agreement to revise price.* The Government and the Contractor recognize that the costs of performing this contract cannot be accurately estimated at the time of its execution and that the contract price fixed in Article — may therefore be either too high or too low. They therefore agree that the contract price shall be revised upward or downward in accordance with this article on the basis of actual experience of the Contractor in producing —% of the items under this contract (hereinafter called the "trial run"). They recognize that the costs of performing that part of the contract will not be typical for the remainder of the contract, but will provide sufficient information and experience to permit revision of the price.

(b) *Estimate of costs.* The Contractor represents that the contract price fixed in Article — is based on a total estimated cost of $....., itemized as follows: [The breakdown of items, including footnotes, is identical to that in paragraph (b) of the Redetermination Article, *supra.* ED.]

(c) *Cost statements.*

(1) Within — days after the completion of the trial run, the Contractor shall submit to the Contracting Officer the following data:[8]

(i) Separate statements showing costs of production for the trial run, itemized in the same way as the estimated cost stated in section (b) above.

(ii) Estimates of the cost of producing the items to be delivered during the remainder of the contract based upon the previous cost experience of the Contractor and upon all other relevant factors.

(iii) Proposed revised prices under the contract.

(2) [This sub-paragraph is identical to sub-paragraph (c)(2) of the Redetermination Article, *supra*, except that it omits the last 7 words in the first sentence therein. ED.]

(d) *Negotiation for revision.*

(1) Upon the filing of the data required by section (c) hereof, the Contractor and Contracting Officer shall negotiate in good faith to agree upon revised prices under this contract. The revised price may be different for different periods of the contract and may be in excess of or less than the price stated in Article — hereof. The agreement reached shall be evidenced by a supplemental agreement to this contract stating the revised price under the contract.

(2) If the Contracting Officer and Contractor fail to agree on revised prices under the contract within thirty days after the date for filing of the data by the Contractor under section (c) hereof, or such further period as may be fixed by agreement, the Contractor, if not in default, or the Government, may terminate the contract hereunder by written notice delivered within ten days after the expiration of said thirty-day period or extension. Upon such termination by either party, the rights and obligations of the parties shall be governed by the provisions of Article — hereof ("Termination for the Convenience of the Government"), except that the Contractor shall be allowed no profit for any uncompleted portion of the contract. If revised prices are not agreed upon and the contract is not terminated, the Government shall pay to the Contractor the price fixed in Article — for the remainder of the contract.

(e) *Payments.* Until the contract price is revised hereunder, the Government shall pay to the Contractor the price set forth in Article — for all articles delivered. If the contract price is revised upward hereunder, the Government shall pay to the Contractor the difference between the prices paid on all items theretofore delivered and the revised price for such items. If the contract price is revised downward hereunder an amount equal to the difference between the price paid on all items theretofore delivered and the revised price for such items, shall be applied as a credit against payments for subsequent deliveries or shall be applied in such other manner or repaid to the Government, as the Contracting Officer may direct. For all items delivered after any price revision hereunder, the Government shall pay the contractor the revised price, minus any such credit. If, before the price is redetermined hereunder, any amount paid under this contract has been included in any renegotiation agreement made under Section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942, as amended, no refund or credit shall be required hereunder with respect to that amount.

(f) *Renegotiation.* Any revision [this paragraph then follows paragraph (f) in the Redetermination Article, *supra*. ED.]

3. *Periodic Adjustment with Exemption from Renegotiation:*

Article —. Periodic adjustment of price.

(a) *Price periods.* The Government and the Contractor agree to adjust the contract price under this contract periodically in accordance with this Article and agree that the performance under this contract will be divided into successive periods for that purpose. The first period will extend from —— to ——; and the second and each succeeding period will extend for —— months from the end of the preceding period.

(b) *Estimates and prices for first period.*

(1) The Contractor and the Government have agreed upon the following estimate of costs for the items to be delivered during the first period hereunder: [The breakdown of items, including footnotes, is identical to that in (b) of the Redetermination Article, *supra*. ED.]

(2) The Contractor and the Government have agreed upon the price fixed in Article — hereof for the first period. The Contracting Officer hereby finds that the provisions of this contract are adequate to prevent excessive profits hereunder during the first period without any renegotiation pursuant to section

[8] Where it will be unduly difficult for the Contractor to submit the data in the form specified in paragraphs (i) and (ii), the following form may be substituted for these paragraphs, if the Contracting Officer is satisfied that it will provide reliable and sufficient data for the purposes of the article:

"(i) Revised estimates of the cost of performing the entire contract, based upon the cost experience of the Contractor during the trial run and upon all other relevant factors, itemized in the same way as the estimated cost stated in section (b) above, and showing separately any reserves for contingencies included in the estimate."

Paragraph (iii) will then be renumbered (ii).

403, the Sixth Supplemental National Defense Appropriation Act, 1942, as amended. The Contractor and the Government therefore agree that the prices fixed in Article — hereof shall be paid for items delivered hereunder during the first period and that such prices for that period shall not be subject to renegotiation under said statute as amended or Article — hereof.

(c) *Periodic statements.* Fifteen days before the end of each period hereunder, except the last, or at such other time or times as the Contracting Officer may fix, the Contractor will submit to the Contracting Officer the following data—

(1) Statements showing the actual cost of producing all items completed for delivery during such period, for which cost figures are available, and such other statements as the Contracting Officer may require.

(2) Estimates of the cost of items to be delivered during the next succeeding period, based upon the previous cost experience of the Contractor and upon all other relevant factors.

(3) Proposed prices for items to be delivered during the next succeeding period.

(d) *Periodic price adjustment—exemptions.*

(1) Upon the filing of the data required by section (c) hereof, the Contractor and the Contracting Officer will negotiate in good faith to agree upon adjusted cost estimates and prices for items to be delivered during the next succeeding period under this contract.

(2) Prices so negotiated and agreed upon may be in excess of or less than the prices stated in Article — hereof. In negotiating such prices consideration will be given to all pertinent factors which have affected the Contractor's costs for items delivered hereunder during any preceding period, or which are likely to affect such costs for items to be delivered hereunder during the next succeeding period, and to all pertinent factors bearing upon the profit margin which is reasonable for the Contractor to earn during the succeeding period. Whenever the Contractor, by skillful management, careful buying, or efficiency in production, has reduced costs experienced during the next preceding period below the estimated amount thereof, and the Government will benefit therefrom by reduced prices from the succeeding period, the contemplated margin of profit for the succeeding period may be increased in recognition of these facts.

(3) After each negotiation, the agreement reached will be evidenced by a supplemental agreement to this contract stating the cost estimates and adjusted prices for the succeeding period. In the discretion of the Contracting Officer, the supplemental agreement may contain a finding that the provisions of this contract and said supplemental agreement are adequate to prevent excessive profits during the applicable succeeding period, and an agreement that the prices fixed for such period will not be subject to renegotiation under section 403, the Sixth Supplemental National Defense Appropriation Act, 1942, as amended, or under Article — hereof.

(4) A disagreement between the Contracting Officer and the Contractor as to an adjusted price for any period will not be subject to Article — (Disputes), and during that period the Contractor shall be paid the price fixed for the preceding period.

(e) *Payments.* During the first period the Government shall pay to the Contractor the price set forth in Article — for all items delivered. During each succeeding period the Government will pay to the Contractor the prices negotiated hereunder for items delivered in that period. If the price for any succeeding period hereunder is still under negotiation and not agreed upon at the beginning of that period, then until an adjusted price for that period is agreed upon, the Contractor will be paid the price fixed for the last preceding period; but after the Contractor and Contracting Officer have agreed by supplemental agreement upon the adjusted prices, an amount equal to the difference between the prices paid on the items delivered in that priod and such adjusted prices will be added to or deducted from payments for subsequent deliveries under this contract or will be paid by or returned to the Government, as the Contracting Officer may direct.

(f) *Accounts and records—statements.* [The first part of this paragraph is identical to sub-paragraph (c)(2) of the Redetermination Article, *supra,* except that it omits the last 7 words in the first sentence therein. ED.] The Contractor represents that the estimates of future costs contained in paragraph (b), and hereafter submitted pursuant to paragraph (c)(2) reflect the best judgment of the Contractor as to probable costs on the basis of previous cost experience and all other relevant factors, and contain no provisions for reserves or allowances not revealed therein.

PRICING IN WAR CONTRACTS*

GLEN A. LLOYD**

Pricing in war contracts probably requires the contracting parties to deal in the face of unknown and changing conditions on a larger scale than in any previous experience. The lack of knowledge of costs, inexperience in making munitions and producing in volume beyond previous experience, at the outset of the war, are now well known. The constant reference to these uncertainties during the early months of the war has, by implication at least, given the impression that they no longer exist in sufficient volume to complicate pricing problems. This impression is inaccurate. It must also be recognized that new types of uncertainties, illustrated by total and partial terminations of contracts, have come into the picture, with the result that proper contracting and pricing in many fields are still extremely difficult.

According to figures recently published by the War Production Board, the 1943 output of war materials will be about 63 billion dollars, with the annual rate during the last quarter at 75 billions, while the 1944 schedule has been set at 80 billions. The 1944 rate is not spectacularly greater than the rate for the last quarter of 1943. These aggregates are not revealing insofar as stability of procurement problems is concerned. It is certain that the 1944 total will involve much smaller expenditures on construction, plant equipment, and certain military items, while the expansion required in other lines is far greater than the totals imply. For example, an increase of 50 per cent in airplane production over 1943 is called for. The many cutbacks and terminations in some lines, as well as step-ups in others, give a bird's-eye view of the extent which instability and uncertainty still dominate many a war production plant.

It must be recognized that many military items are necessarily less stable in design than most commercial products. This is true for three principal reasons: First, one of the major objectives in war production is steady improvement of the implements of war, and these improvements are constantly flowing through from

* The opinions expressed in this article are those of the author and are not to be taken as representing official views of the War Department.

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orderly engineering developments; second, changes are constantly required to meet new developments introduced by the enemy; and third, the timing and kind of warfare in the different theaters is directly responsible for shifts in the quantities and characteristics required of many items.

Changing circumstances make it difficult to contract on a fixed-price basis even for short periods of time and doubly so for long periods. The choice of whether a contract shall be for a short or a long term is frequently not within the discretion of the contracting parties. Many long term commitments are unavoidable. This is true not only from the necessity of complying with CMP requirements, but even more often to meet the normal requirements incident to the flow of production. The failure to place orders and make advance allotments would prevent the contractor from obtaining a preferred position on the schedules of manufacturers of components and on the schedules of controlled materials producers. In some instances delay in placing orders and failure to make advance allotments might prevent the manufacturer from passing allotments down through the chain of subcontractors and suppliers in time to get orders for controlled materials placed during the quarter for which the allotments are valid. Because long-term commitments make proper pricing more difficult, it is highly desirable, on the other hand, to keep commitments as short as will assure orderly delivery of the material. Nevertheless this assurance has required and will require many contracts for deliveries extending 12 months or more into the future.

In this setting, problems which arise in the negotiation of sound prices at the time contracts are originally placed become easier to comprehend. The necessity in many instances for some form of price adjustment or renegotiation after at least part performance is also more apparent. In fact, if one dwells intensively upon the number and variety of shifting circumstances which frequently come into the picture after the original negotiation, to alter manufacturing plans, costs, and potential profits, one may persuade himself that attempts at careful buying of war materials are not worth the candle. Many people, both within the Government and in industry, have so persuaded themselves. It has been forcefully argued that the very conditions cited were the reasons why the renegotiation statute was passed, and that with it and the excess-profits tax law as backstops, little time and work should be spent on original negotiations. A second point of view goes even further and urges not only casual original buying but also repeal of the renegotiation law. This view appears to hold that the only evil of loose pricing is the possibility of the accrual of excessive profits and that for all intents and purposes that problem will be handled adequately by the excess-profits tax law, as it stands or with amendments. The third general point of view is that with or without the aid of statutory renegotiation the negotiation of contracts should be conducted on a business basis in a determined effort to arrive at a contractual relationship which is sound and defensible from the standpoint of both parties. The latter view has now been

pretty generally accepted by war procurement agencies and is the one on which this article is premised.

OBJECTIVES OF A PRICING POLICY

The term "close prices" is frequently used. This term in the sense in which it is used does not necessarily mean prices which are the lowest obtainable from a given contractor, but rather those found by careful, practical analysis to be fair and reasonable in the circumstances of the particular procurement. It might be said that close prices are those, as nearly as obtainable, which would exist under competitive conditions. The object is, to a large degree, merely to put into war purchasing by what might be called artificial or synthetic methods what competition normally contributed to peacetime buying.

The urgent importance of getting out production of the right quality and on time is beyond debate, but the importance of doing so on a business basis has frequently been questioned. Those who believe that the time and energy devoted to improving contracting and pricing methods could be better utilized in some other phase of the war effort, must necessarily take the position that the principal importance of these functions is to save money and that they have no effective relationship to efficient operations or adequate production. The trouble with this position is that it is not borne out by industrial experience. The most convincing proof that it is not borne out by experience is the long record of improvements in manufacturing methods and techniques made under the pressure of competitive prices. Also there are many examples in the procurement program which strongly indicate that satisfactory contractual relationships, including close prices, have a decided influence upon production methods and controls. There are also striking examples of the damage which can result to production from loose contracting and pricing practices. If the necessity of making a profit out of a close price has been as strong a force in manufacturing operations as experience in both peacetime and war production indicates, then the pricing phase of war procurement becomes a function not merely of dollars spent or saved, but of production and morale. Properly negotiated prices in this sense may contribute more toward winning the war and to effective postwar competitive positions of war producers than will the money saved.

It has often been said that no one knows what a proper price for a machine gun, a tank, or a bomber should be, and therefore excessive time spent in trying to find out is both futile and wasteful. It is undoubtedly true that no one does know what prices for such military items should be in an abstract sense, and that they cannot be discovered by mathematical abstractions. When related, however, to the specific conditions of a given procurement from an identified producer, overall disclosure of pertinent information dealt with by the contracting parties in a thoroughly cooperative manner through a high order of negotiations, presents a very different picture. In many instances the capacity of marginal producers is required, and a right price for such a producer may and often does vary substantially from a proper price to a more efficient producer. The soundness of differentials in prices

lies in understanding the reasons for the differences. In each important procurement there is an ideal price which would provide effective pressures and incentives to insure efficient operations and maximum production. Perfection, of course, cannot be attained, but the right kinds of cooperation and negotiations are constantly bringing prices within the practical limits of the objective.

In view of the relatively longer experience with war production in England, it is significant to note the conclusions of the Select Committee on National Expenditure in its Fourth Report to the House of Commons:

> "The effort to maintain or restore some incentive to cheap production, which is the object of such modifications in adjusted price contracts, has been disparaged on the ground that output is more important than price and that attempts to effect paltry economies may seriously disturb the productive organisation. The answer to this lies in the relation between costs and efficiency, which experience shows to be so close that maximum output is unlikely to be attained under conditions in which costs are to any considerable extent above the minimum. Unwillingness to press for a return to fixed prices seems to be associated with the misapprehension that maximum output and economy are distinct and frequently incompatible aims. Maximum output is essential; but, if it is to be achieved, the expenditure of national resources—whether in man-power, in materials or in capital equipment—must be at a minimum for each unit of output; and one indispensable method of bringing this about is to pay the closest attention to sound methods of contract procedure. . . .
>
> "The prime necessity in a war economy is for the maximum and most efficient use of man-power and materials. It is a fundamental mistake to suppose that a form of output may be comparatively expensive in terms of money and yet cheap in terms of these real resources."

The principal objectives of a sound pricing policy may be summarized in this manner: (1) Stimulation of higher production through efficiency and economy—the reduction of costs, both money costs and costs in materials and labor (unless such a policy is concentrated upon constantly more efficient use of labor, materials and machinery, it leaves contractors with little incentive to resist increases in wage rates and material costs and thus puts added strain on price and wage controls; inefficiency in war production also flows over into and directly affects civilian production, increases shortages of such production and aggravates the problems of rationing and price control; this is one of the most serious dangers of unsound procurement and is difficult to remove in most instances by any method other than close pricing at or near the inception of war contracts); (2) checking inflationary tendencies created by higher purchasing power, higher costs and fewer supplies on the market; within the military field this objective is closely tied in to the terms of actual procurements and cannot be handled by general policies and standards such as those available to OPA in its anti-inflation objectives and to the Treasury in administering the excess-profits tax law; (3) preventing public outcry and injury to morale; and (4) controlling costs of the war.

PRICING METHODS

One of the most frequent mistakes made in pricing methods and in organizations set up to administer them is the presumption that contracting and pricing are made up of a series of independent elements. This leads to a mechanical system which has different people working independently on such things as comparative prices, cost breakdowns, contract clauses, financing provisions, and other price factors. Under this system no one person or group with a knowledge of all pertinent factors and with an understanding of their relationship to one another, can ever exercise judgment on what the final price should be. One of the most important phases, for example, of the War Department's present pricing program is an effort to integrate factual developments and negotiations. This system enables final judgment to take into account the use of such approaches as comparative prices, costs and trends of costs, contract provisions, and information developed in statutory renegotiation.

Comparative Prices

The practical utility of comparing prices is known to anyone who engages in the every-day activity of buying necessities. If the prices of two merchants differ substantially, the ordinary buyer either makes the purchase at the lower price or satisfies himself that the higher price is justified for some reason or other. Buying war materials is much more complicated because it is often essential to make use of every productive facility regardless of price and because valid comparisons are frequently much more difficult to make, as well as for other reasons which will appear hereinafter. Nevertheless, an intelligent comparison of prices is of value in furthering the object of buying war goods at right prices.

Price comparisons, without further analysis, can often be used to effect price reductions of peacetime items purchased for war uses. Under peacetime conditions, producers did not receive higher prices merely because they had higher costs. Differences in costs were absorbed within relatively similar prices and were reflected by different profit margins. There is, therefore, little need for allowing price differentials for ordinary commercial items because of higher costs. Comparisons of prices should govern the price analysis in most cases. This does not mean that peacetime prices will be paid for ordinary commercial items. The large assured volume brought about by war orders has substantially reduced the costs of many producers, and this fact should be taken into account in negotiating the prices to be paid.

Even with respect to strictly war materials, it is not uncommon for a skillful negotiator to employ comparative prices as a means of persuading high-price producers to bring their prices into line with low-price suppliers. The typical American manufacturer does not want to be known as one who sells at comparatively high prices. He desires, moreover, to maintain his place in competing for post-war business, and he knows or can be shown that high prices for war goods may lead

to inefficiencies which may continue after the war and impair his ability to compete with other and more economical producers. In this way the force of competition may be injected into the buying of war goods.

In many cases, however, the comparison and the process are not so simple. The Government representative must acquaint himself with the factors which tend to invalidate the comparison and must, in any case where the factors differ, perform the difficult task of reducing those differences to the common denominator of dollars and cents. Some of the more important of those price factors will now be briefly considered, after which appears a short discussion of the use of price indexes as an aid to sound pricing.

Specifications.—It is obvious that differences in specifications may justify or require differences in prices. The negotiator must acquaint himself with the technical differences between the items being compared and then, with whatever expert assistance may be available, evaluate those differences in terms of money.

Size of the Order.—No argument is necessary to establish that the factor of volume may have an important influence on the comparability of prices. It is clear that the unit price for 10,000 units should normally be lower than that for 2,000. On the other hand, there may be exceptions in cases of overloading, where the point of diminishing returns is reached and "creeping costs" begin to appear.

Delivery Schedules.—A contract calling for deliveries over a long period of time may have higher prices than a contract providing a shorter delivery schedule, because there are greater uncertainties and hence greater risks under the longer-term agreement. As pointed out below, the influence of such risks on prices may be affected by contract provisions for shifting the risks to the Government.

Government-Furnished Materials and Facilities.—Where the Government supplies a contractor either materials or productive facilities, or both, it is manifest that the price of that contractor is not comparable with prices of other producers who are not receiving similar treatment, unless an appropriate adjustment is made.

Financing Provisions.—In a case where the Government assists a contractor in financing his operations, by way of advance payments, unit payments, progress payments or the like, his prices are not fairly comparable with those of other producers without an adequate adjustment.

Royalties.—An adjustment is also necessary when one producer pays for the use of patent rights and the others do not.

Sub-contracting.—The influence of sub-contracting on the comparability of prices is subject to no single generalization. In some cases it may result in prices higher than if the prime contractor had himself fabricated the sub-contracted component. In other cases the prices may be lower. In still other cases sub-contracting may not affect the price in one way or the other. The one point is certain that it is generally difficult to evaluate the effect of sub-contracting on the price of a given producer.

A comparison of prices of important sub-contracted items is of considerable value in bringing about close pricing. It not infrequently occurs that one contractor pays more than another for an identical item obtained from the same subcontractor. A higher price for an end item may result from an excessive price for a sub-contracted component, which fact may be discovered by the simple process of comparison.

Comparing Individual Prices.—Notwithstanding the fact that only limited conclusions can be reached from price comparisons because they merely reveal differences and do not explain them, they can often be used effectively in obtaining prices which are fair and reasonable. Thus, where the price factors and conditions of production are essentially similar between two contracts, prices should be similar. This similarity of price factors is found usually in (a) contracts for the same item with the same contractor, and (b) contracts with different contractors for standard commercial items.

It can generally be assumed that the price for an extension of an old contract or the price in a new contract covering an item in production should be no higher than the price under which deliveries are currently made. In many instances improved manufacturing techniques or increased volume will require that the new price be lower.

Notwithstanding differences in price factors, comparative prices can often be used directly to effect a price reduction. This is true because they permit the contracting officer to inject a competitive force into his buying. No contractor derives satisfaction from being the highest-price producer, and many will reduce prices simply to meet the lower price of another. Many corporations recognize that their post-war market positions will depend upon their comparative efficiency and ability to meet competition. They recognize that close prices have virtue in developing increased efficiency in production and for this reason will accept a competitive price reduction.

Comparing Price Changes.—Comparisons of individual prices are not so effective in revealing overpricing when applied to items whose manufacture is attended by wide variations in costs. These items, in the main, are those whose use is restricted solely to war and which are being produced by companies having widely varying peacetime activities and corresponding variations in manufacturing facilities. For such comparisons to be direct, price factors must be identical, a condition which often does not exist.

Perhaps the most effective price comparison to use in regard to non-competitive items is that which compares the price changes of one contractor with those of another for the same or similar item. Thus, it is assumed that even though prices are at different levels, experience in manufacture should result in price reductions by all contractors and that the rate of the reductions should be similar. To the extent that one company's price trend does not follow the decline of others, overpricing may be suspected.

The following records actual price actions on contracts for the same commodity produced by three contractors:

Company	*March 1942*	*June*	*July*	*August*	*December*
1	$52.50		$45.13		$38.69
2	56.00			$55.90	
3	58.50	$58.50			53.39

The first recorded price change occurred in July when Company 1, the lowest-price producer, reduced its price by 14 per cent. During August, Company 2 obtained a price practically unchanged from that which existed since March. Query: Why was there no greater reduction when compared with the 14 per cent decline registered by Company 1?

By December, Company 1 had reduced its price to a level 26 per cent under that of March; Company 3 had reduced its price by 9 per cent; and Company 2 remained unchanged. These comparisons indicate an inquiry into the prices of the two high-price producers.

The application of a number of price series as a yardstick is not a mechanical procedure. The fact that price changes of one company are wholly dissimilar to those of a number of other companies may suggest inspection of the majority rather than the one. Thus, the following prices were paid to a number of producers of one standard item:

Company	*Feb. 1942*	*April*	*May*	*Sept.*	*Nov.*	*March 1943*
1	$5.00	$5.00	$3.85	$4.35	$4.10	$2.50
2	7.00	6.00	6.00	6.50	6.50	6.00
3	7.00	7.00	6.50	7.00	6.50	
4			7.30		7.30	6.50
5			6.37	6.87	6.87	
6				7.25	7.25	6.25
7			6.50	7.00		6.50
8			7.25	7.75	7.75	6.50

The sharp reduction in the price of Company 1 (from $5.00 to $2.50), which started with a lower price, makes the prices of the other seven subject to question. The March, 1943, prices reflect such a wide range that differences in contractual and production circumstances would be examined.

The comparison of price movements does not require identical price factors. Therefore, it has been found that this method may be used for several non-identical items which are influenced by similar circumstances. Thus, a .50 caliber machine gun and a .30 caliber machine gun require similar materials and processes even though their production costs are not readily comparable. Therefore, a downward price movement for a .50 caliber gun would cast some doubt on the justification of increasing the price for a .30 caliber gun.

As might be expected, analysts who have compared many price series for the same or similar items will find that their procedures have become more and more

complicated as the number of series increased. The War Department is, therefore, developing a component series, which will reflect the *average* price movements of a number of items, to use as a yardstick in analyzing the price of one contractor.

The computation of average price movements, in the War Department, is resulting in a number of price indexes. A price index is being constructed for each of the major commodities, together with several overall indexes. The price analysis function is being coordinated with the index work on two bases: price analysis supplies the basic price information and will use the final indexes in aid of close pricing of future purchases.

Through the index material it will be possible to simplify many of the tasks of analyzing comparative price movements. As the specific indexes are applied, their usefulness will increase. In many cases the regularly prepared index series will be applicable to specific price situations. However, a price analyst may find that a new index, or a variation of a standard one, will apply to some of his specific problems more directly. In that event, it may be that a new index can be readily constructed to fit his specific needs.

Through these indexes the individual analyst is in a position to see the general trends of prices; whether certain key items are going up or down in other sections of the country; whether the prices of certain end items, such as airplane engines, are being reduced more quickly than those of others, such as air frames; what factors seem to affect these broad situations; and what to examine more closely in the individual procurement. The indexes will thus become a device to further the War Department policy of close pricing.

Cost Analysis

It is often necessary to go beyond the analysis of comparisons in order to understand a price. Items purchased under several contracts may not be exactly comparable. There may be differences in specifications, Government-furnished equipment, Government-financed facilities, volume and risk factors. Therefore, an evaluation of the differences may be necessary in order to understand the price. In many cases it may be necessary to pay a higher price to one contractor because he is compelled to utilize high cost operations which cannot be replaced. Many procurements involve completely new items for which there are no comparable prices.

In this setting the analyst must go far beyond an accounting analysis of profits. He must look into the factors affecting costs and the basis for their evaluation. He must look into the possibilities of reducing costs by efficient production methods. He must consider the influence of the prices allowed on future efficiency and costs.

The forward look at costs cannot be applied mechanically. If cost analysis called merely for the addition of the elements of cost plus a profit, the influence of prices on costs and productive performance might be overlooked. Cost estimates for forward pricing require a considerable amount of business evaluation. Although past

costs are a good starting point, their future projection involves the exercise of sound judgment. For example, there may be differences in volume factors, wage rates, productive methods, and the relative efficiency of the operating organization, all of which must be intelligently evaluated.

On that account cost analysis in the procurement field must be regarded as an integral phase of price analysis. The examination of costs cannot be based upon either of the theoretical extremes of cost estimating. On the one hand, there is little to be gained from a complete cost accounting which follows through on all of the elements of cost for each individual part going into the final product. On the other hand, it is impracticable to estimate the costs of producing an item by the simple method of hefting it and looking it over. The cost analysis which should be utilized in this field must be based upon a practical effort to evaluate the particular problems which face the price analyst.

In many cases the major components of a final price will be found in the prices which the prime contractor pays for several sub-contracted components. In that event the analysis may be substantially complete by an evaluation of the prices paid for the components, including a study of comparative prices and of price factors affecting the sub-contract.

In many cases the study of comparative prices and factors will show specific differences which should be evaluated in cost terms. For example, one product may require the addition of several parts to the item which was purchased under a previous contract. If there is a substantial price justification for the previous contract, the cost analysis would essentially be a study of the cost of the additional parts.

The analysis of differences in cost factors is especially important in considering the prices paid for spare parts in many contracts. If all the parts used in the end product are purchased as spares, it is possible to build up a synthetic price for the final component unassembled, as in the case of engines. The analysis of the spare parts prices may be carried out by comparing the prices of spares, less the cost of special packaging, with the prices of the finished engine, less the cost of assembly, testing, and packing. Through this synthetized comparison it is often possible to tell whether or not the prices paid for a set of spares are sound in the light of the prices paid for the completed item.

When cost analysis is developed for a major procurement, the type of the total analysis will depend upon the nature of the end item and the cost problems which affect it. For example, an analysis of substantial price differences for an insecticide disclosed wide differences in the cost estimates for materials which two contractors submitted. An examination of these cost estimates disclosed that the high price contractor was contemplating the use of a very high proportion of an expensive raw material, whereas the low price manufacturer had estimated his costs on the basis of a smaller proportion of that material. An examination of the specifica-

tions disclosed that they did not require the larger quantity of the costlier material. With this information it was possible to show the contractor that his mixture of the materials should be changed and his price reduced. On the other hand, the procurement of a complicated item, such as radio equipment, carbines, or airplane engines, may require a detailed analysis of various elements going into cost comparisons with past and standard costs and an examination of the bases for the future cost estimates. Such an examination may call for a review of the contractor's cost accounting system and engineering estimates to check into the reasonableness of the cost forecasts. The discussion of costs may cover the bases for the forecast, expected changes in conditions, improvements in methods and in efficiencies and in the possibilities of reducing costs of sub-contracted items.

In a cost examination covering more complex items the relationships between price policies and productive performance become very clear. If a contractor's cost accounting system and cost estimates show that the contractor does not have cost records which reflect the efficiencies of his own operations, production as well as prices will be affected. The contractor who is watching costs in order to develop close prices is also watching costs in order to develop more efficient performance. On the other hand, the contractor whose cost information, including the data secured from his formal cost accounting system, engineering reports, and production schedules, is calculated to produce justifications for high prices, may very well conduct a decidedly inefficient operation.

At this point the analysis of costs must include a consideration of accounting control systems, engineering and production controls, relative operating efficiencies, and the factors affecting unit costs in order to develop an intelligent analysis of prices. Labor costs may be checked by analyzing the number of labor hours required for the total production and for component parts. Material costs may be analyzed by examining the total amount and type of materials used, scrap and salvage, and prices for sub-contracted parts. Through these two examinations it is often possible to detect relative inefficiencies as between producers. This analysis may have a direct effect not only on the prices but also on the production methods. For example, through such a consideration it was discovered that a high price contractor had been using hot rolled steel when cold rolled steel could have been used. As a result of the negotiations the producer changed to cold rolled steel, reduced his costs and prices, and increased his efficiency.

In some few cases cost surveys have been made of all the major producers of a particular item. These studies have shown cost differences which reflect clearly differences in production methods and efficiency. In those cases the price reductions were accompanied directly by improvements in productive performance which the less efficient producers were induced to make as a result of the studies.

It is impossible to develop any simple generalization about the kinds of cost analysis which a close pricing program requires. Since each analysis must be tailored to the particular procurement on the basis of the range and type of problems

presented, there can be no set pattern for cost examinations or evaluations. The complete accounting approach will not meet the requirements, nor will the complete engineering approach. The success of a realistic cost analysis program will in final analysis depend on the extent to which cost analysis implements and supports the overall function of price analysis.

A few producers for the war have been reluctant to furnish product costs for pricing purposes on the grounds that such information is confidential and that costs are immaterial in the fixing of prices. They point out that it was not customary to furnish peace-time buyers with costs of production and conclude that there is no more reason to furnish them to the Government as a war-time buyer. Most producers, however, have recognized that the use of product costs is the only effective substitute for peace-time competition and that they themselves are much better off to have this information in the hands of contracting officers. They feel that a contracting officer without the aid of effective competitive bids and with no reliable knowledge of a particular contractor's costs, is more likely to be arbitrary and unreasonable in his ideas of what prices should be. Contractors, therefore, find their own best protection in a policy that assures full information to the contracting officer on all factors pertinent to a transaction, even when this requires going beyond the requests made upon them.

Significant progress has been made in use of the type of cost analysis outlined above, which to a substantial degree is responsible for the steady progress being made in the pricing of war goods. This type of cost analysis is much broader in scope than an accounting approach. In addition to placing a heavy responsibility upon contractors to keep adequate records, it calls for an intelligent job of appraising and evaluating cost and price factors. Any war contractor who has not assumed this responsibility is indeed in a poor position to complain about arbitrary actions of Government procurement agencies.

Contract Provisions

On account of the uncertainties arising out of changes, for example, in volume and specifications, referred to at the outset in this article, the possibility of increases in costs of labor and materials, and various other business hazards occasioned by the abnormalities of the war, it might well be argued that war contracts, especially those involving long-term commitments, should be made on some kind of cost-plus basis. In that way risks over which the contractor has no control, and for which he is not responsible, would be shifted to the Government, and the contractor would be virtually assured of some profit. Such a blanket solution of the problem, however, does not meet with favor by Government procurement agencies. Although the statute forbidding the use of cost-plus-a-percentage contracts expressly permits the use of cost-plus-a-fixed-fee contracts, agreements of the latter type are contrary to the policies of the Government in many fields of procurement. The reasons for this view are (a) that the fixed-fee contracts do not encourage efficiency to

the same extent as do fixed-price contracts and so do not lead to an economical use of man-power, materials and machinery or to improvements in manufacturing methods and processes; (b) that the administration of such contracts requires extensive and uneconomical use of accounting and other personnel; (c) that such contracts may lead to unsound competition for labor and the accumulation of inventories; and (d) that they do not bring about maximum production as effectively as do fixed-price agreements. For reasons such as the foregoing it is the announced policy of the War Department that "supply contracts will be made on a cost-plus-a-fixed-fee basis *only if no practicable alternative exists.*"

The true purpose of cost-plus-fixed-fee type of contracting has sometimes been misunderstood. One view seems to hold that the uncertainties in war buying make fixed-fee contracts appropriate in virtually all fields of contracting, while another condemns them altogether. Both views are extreme and, from the standpoint of relating contracting methods to production needs, are open to question. The questions of whether such contracts should be used and to what extent are not legal or abstract. These questions are significantly related to obtaining required results under given circumstances. For example, it might be extremely important in meeting military requirements that ammunition containers be produced in highly fluctuating quantities. These containers are too bulky for extensive storage or long hauls, but loading plants often cannot anticipate requirements far in advance. Yet such requirements, when known, are urgent. Under these circumstances a fixed-price contract would make it impossible to meet the necessarily erratic delivery schedules without abnormally high unit costs and prices. The determining factor in such a case should not be a pre-existing prejudice, arbitrary rule, or the success of a superior bargainer. The selection of the form of contract, as well as other features of the transaction, should be made in the manner most calculated to draw out maximum production from an existing situation.

The economic use of cost-plus-fixed-fee contracts may cover a wide range of conditions, such as necessity of extremely large volume from companies with small invested or working capital, early peak production, experimental and developmental work, or need for unusual flexibility of operations. If failure to use a fixed-fee contract seriously threatens the loss of these essential aspects of production, the question of whether it should be employed answers itself. Procurement policies based on this point of view do not leave the area for fixed-fee contracting to be dictated by mere failures in negotiations for fixed prices. The area is defined by production requirements, and a procurement policy squarely based on meeting such requirements does not need to be defensive or apologetic for merely recognizing production necessities. The secret is to locate this area of contracting and limit the use of fixed-fee contracts to it. Because many fields of war contracting have, in varying degrees, some of the characteristics of the areas within which fixed-fee contracting is sound, the decision on whether or not to use such contracts is not always easy. The area cannot be defined by inflexible rules. Thus, in many cases

several of the conditions warranting a cost-plus-fixed-fee contract may be effectively handled by appropriate clauses in fixed-price contracts. The process of selection gets back to the basic method for all war buying, that is, flexible negotiations based on full disclosure of pertinent facts and a thorough understanding of production needs and problems. The added administrative burden should, of course, be taken into account. The difficulties with this form of contracting center around its inappropriate application and ineffective administration rather than complete impracticability. The Government and war contractors should use the same standards in reaching decisions on which form of contract to use, since their production objectives are the same.

If fixed-fee contracts are not countenanced (except in certain areas of contracting) and war contractors are urged to commit themselves to fixed-price contracts, they will naturally seek to protect themselves against loss by including in their costs and prices charges sufficiently large to cover every possible contingency that might arise in the period of performance. Such a course is simply an application to a wartime problem of an accounting device designed to protect a businessman against losses of various kinds in time of peace as well as in time of war. The difficulty with its use in the pricing of war contracts is that the inclusion of contingency charges effectively prevents purchases at close prices. The question thus presented is, how are close prices to be obtained in view of all the uncertainties and risks resulting from the vagaries of war?

The answer to that question is that the risk resulting from such abnormal, war-caused uncertainties and hazards may be shifted, by contract, from the contractor to the Government. In other words, an intelligent application of contract provisions may give the contractor some of the certainty he desires and thereby induce him to commit himself to closer prices. The contract provisions which are presently used by War Department procurement agencies to effect such shifts of risks may be divided into two broad classes: (1) provisions designed to protect the contractor against virtually all cost increases not subject to his control; (2) provisions designed to protect him against specific cost increases. Of these in order:

General Price Adjustment Provisions

Negotiated Revision of Entire Price.—The authorized article[1] provides for one upward or downward revision of the entire price by negotiation on the basis of a "trial run," which shall be from twenty to forty per cent of production under the contract. The revised price may be different for different periods of the contract. Upon failure to agree upon a revised price, either party may terminate within a specified time. The article is to be used only in cases where the developmental or experimental nature of the item or lack of production experience or other causes preclude reliable cost estimates when the contract is made and make price revision essential. It should be noted that use of the provision is predicated on the con-

[1] For text of the article, see Appendix to Marbury and Bowie, *Renegotiation and Procurement, supra* 218, at 232.

tractor's elimination of substantially all contingency charges. As an incentive to the contractor, his profit margin may be increased if he reduces costs and prices by skillful management, careful buying or efficient production.

A related article[2] provides for downward redetermination of price on the basis of a formula. The authorized provision divides production into three periods: the preliminary run, the test run, and the remainder of the production. By the formula the cost of the remaining production is regarded as the same as the cost of the test run, and if those costs, together with the cost of the preliminary run, are less than the original cost estimate, the entire price is to be reduced by the amount of such difference. This clause is designed for use in certain cases where production cost cannot be estimated with reasonable accuracy when the contract is made, as in the case of entirely new items, experimental products, items subject to radical change, or where the contractor is wanting in experience.

Periodic Price Adjustment.[3]—These articles provide for a negotiated upward or downward adjustment of the price at the end of periods which may be fixed at from three to six months. In one of the articles the price for the first period is fixed, and in the other it is subject to a retroactive adjustment for the first period similar to the prospective adjustments for the succeeding periods. Every such adjustment is based on the cost experience for the preceding period or periods and on all other relevant factors. Either of the clauses may or may not provide for exemption from statutory renegotiation. Particularly where such exemption is provided for, there must be a substantial elimination of charges for contingencies and a relatively low profit margin. If costs are reduced and the Government benefits thereby through lower prices, as a result of the contractor's efficiency, the margin of profit may be increased for succeeding periods. The use of these articles is limited to cases where accurate cost data on the production are or will be available when the adjustment negotiations take place.

Revision of Price.—Where the price may be fairly fixed for the initial period but not for the remainder of the contract because of the uncertainty of future conditions, this article provides for a single upward or downward negotiated revision of the price at the end of that period. The revised price may be different for different periods, but the revision applies only to the remainder of the contract, not to the initial period. As in the case of the articles previously discussed, the price here must contain substantially no allowances for contingencies. Either party may terminate upon failure to agree upon revised prices.

Escalation in Relation to O.P.A. Ceiling Prices.—Although escalation is generally contrary to War Department policy, there are certain extraordinary cases where it may be used. The use of escalation clauses has been authorized in relation to lumber, coal, and fuel oil and gasoline. In the case of lumber the price fluctuates up and down by the same number of cents that the O.P.A. maximum price may be increased or decreased. With respect to the other products named,

[2] *Id.* at 231. [3] *Id.* at 233.

the authorized articles provide for an increase in price by the same number of cents that the O.P.A. maximum price may be increased, for a decrease if such maximum price is reduced below the contract price, and for a redetermination of the price by negotiation at the option of the contracting officer. Such clauses are generally applicable to contracts running for a period of six months or more.

A somewhat similar provision is authorized in respect of rubber and other products where the Government actually fixes the price, as distinguished from cases where the Government merely prescribes the *maximum* price. The rubber article provides for an equitable adjustment of the price if the agreement between the War Department and Rubber Reserve Company shall be revised or terminated and the specified prices to the contractor for rubber are in consequence increased or decreased.

Depending on their use, it might be that clauses last discussed would fall into the second broad class referred to above.

Protection Against Specific Risks

Changes Article.—Where the contracting officer is empowered to make changes in (i) shipping and packing directions, (ii) quantity, (iii) drawings and specifications, or (iv) delivery schedules, and such change or changes cause an increase or decrease in the amount of work or affect other cost factors, the article provides for an equitable adjustment of the price. In return for the inclusion of the clause the contractor is expected to eliminate reserves or allowances for the risk incident to such change or changes.

Increase in Cost of Freight.—Two provisions are available for protection against this kind of risk. One clause provides for an increase in price in case of an increase, authorized by the Interstate Commerce Commission, in freight rates on specified materials, after the date of the bid or the award. The other provides for an equitable adjustment of price if a change in the cost of freight on steel results from priority or allocation orders of the Government. The inclusion of either clause is predicated upon elimination of charges for the risk for which protection is given.

Changes in Delivery Schedules.—Whenever interruption of the production schedules will substantially affect the contractor's cost and there is a serious risk of such interruption by Government action, the authorized article provides for an equitable adjustment of the price (a) if the rate of deliveries is reduced by partial termination of the contract for the convenience of the Government or (b) if the contractor is prevented from following the delivery schedule by preference, priority or allocation order of the Government, and in consequence the contractor's cost is substantially affected. As in other provisions for the shifting of risk, the contractor is required to exclude allowances and reserves for such hazards.

Taxes.—The standard tax article contains a provision for an increase or decrease in price in case certain taxes are imposed on the contractor or in case he is relieved of liability for such taxes.

Even if the contract makes no provision for price adjustment or if the provision contained in the contract does not cover the particular exigency confronting the contractor, the policy of the War Department is to relieve the contractor from losses or threatened losses for which he is not responsible. Such relief is effected by a contract amendment which may or may not be supported by consideration. Examples of amendments with consideration which may result in price increases are: changes in specifications, delivery schedules, or the like; when the contractor's right to perform the contract according to his own methods is modified or restricted by the amendment; when the amendment changes volume or rate of production so as adversely to affect costs; and whenever the amendment is otherwise to the Government's advantage and is based on legal consideration.

Under the First War Powers Act and Executive Order No. 9001, amendments may be made without consideration. It is the general policy of the War Department to allow contract amendments to meet changed conditions when such action will facilitate the prosecution of the war. Examples of cases requiring amendments of this kind are: where the contractor has suffered or will suffer loss or lower profits as a result of a bona fide mistake of fact or as a result of Government action; when changed conditions result from enemy action or special circumstances of the war; where productive capacity or efficiency will be impaired by actual or threatened loss on a war contract; or where administration may be improved by an amendment.

Upward and downward adjustment of price is also provided for in connection with problems arising out of the Controlled Materials Plan.

It is apparent from the foregoing summary that the War Department has taken substantial steps directed toward elimination or reduction of many of the contractor's risks which are peculiar to war conditions. Proper use of the devices so provided should result in closer prices than would otherwise be possible.

INCENTIVE CONTRACTS

Some of the War Department provisions for fixed-price contracts, discussed hereinabove, give the contractor incentives to reduce costs by allowing greater profits and profit margins if he reduces his prices through efficiency. In cost-plus-a-fee agreements, and in other types of contracts with other Government agencies, similar incentives may be employed by the use of "target" prices or other like devices. The general tenor of such provisions is to allow the contractor a larger fee or profit if he succeeds in reducing costs or prices below a stated amount.

The War Department has an authorized provision of this type for incorporation in cost-plus-a-fee agreements. The article provides for the fixing of the target estimate after preliminary and test runs, and the adjustment of the fee upward or downward after complete performance of the contract. The fee is increased if the

experienced costs are lower than the target estimate and decreased if such costs are higher. Both a maximum and a minimum fee are prescribed.

A considerable amount of publicity has been given recently to Navy Department incentive contracts, although few such contracts thus far have been written. The agreements provide for a "contract price" and a "target cost." Ninety per cent of the cost savings below the "target cost" is deducted from the contract price. In effect, the profit margin is increased by ten per cent of the estimated cost savings. One hundred per cent of the increased costs is added to the contract price up to a specified maximum. The "contract prices" and "target costs" are set for succeeding quotas of production.

The Maritime Commission has several types of target price contracts. (1) The cost-plus-a-fee contracts for emergency cargo ships provide for adjustments of the fee based upon the number of man-hours used. The base fee is set in the contract along with delivery schedules and man-hour estimates. The fee is to be increased on the following bases: man-hours saved times fifty cents, and a bonus of $400 per day for deliveries ahead of schedule. The fee is to be decreased on the following bases: man-hours used above the estimates times 33⅓ cents, and a penalty of $400 per day for delays in delivery. Maximum and minimum fees are set. A maximum price is set—but it can be changed.

(2) The Maritime Commission's "price minus" contracts for concrete barges provide for costs-plus-fees adjusted on the basis of dollar savings. A basic contract cost is set, subject to escalation for changes in wage and material price indexes and changes in specifications. A base fee is set, usually at one and one-half per cent of estimated cost. The contractor's fee is adjusted by fifty per cent of the difference between the adjusted and the actual costs. In addition, penalties and bonuses for late and early deliveries are provided at a fixed amount per day. A maximum fee is set, usually at seven per cent of estimated cost.

(3) Recently, the Maritime Commission started to negotiate a third type of target price contract for merchant vessels. This provides for fixed prices and for the refunding of all profits in excess of maximum profits allowed. Exemption from statutory renegotiation is provided. A base price and a maximum allowable profit are established in the contract. If the base price is lowered for successive groups of ships, the maximum profits which may be retained are increased. In other words, when a contractor reduces his price, he takes on the risk of additional losses in return for which he may retain larger profits. The base prices are subject to escalation.

Problems in Administering Target Price Contracts

At first blush, the target price contract seems to provide considerable incentive for improved operations and cost controls. Since the contractor is given an additional reward for cost savings and suffers a penalty for cost increases, he should have strong incentives for improving his productive operations. However, this in-

centive approach depends upon the accuracy of the cost estimates which are provided and the administrative efficiency of the audit procedures.

High Target Prices.—The general concensus seems to be that most target prices have been set too high. The contractor is paid not so much for increased efficiency as for poor estimating. The Bethlehem Steel case[4] was based on target price contracts entered into with the Emergency Fleet Corporation during the last war and exhibited some of the disadvantages of this approach. Some who have examined target price contracts used during the last war have come to the conclusion that the targets were generally too high. The British Select Committee on National Expenditure has found that target price contracts are impracticable for use in the present war.

Low Target Prices.—Because of the problems presented by target prices which are too high, it has been suggested that the solution might be found in lower targets. It has even been suggested that the costs of the most efficient producer of a product be used as the target. Such a procedure, it is felt, would eliminate temptations to blow up the basic cost estimates. However, a target price system will not encourage industrial incentives if the target prices are unrealistic and discouraging. A contractor who is offered a reward for cutting his costs below an impracticable level would have no more incentive for reducing costs than under a cost-plus-fixed-fee agreement. Therefore, setting an effective target price requires an examination of the level of costs which may be achieved in the individual plant, taking into consideration available equipment, labor and materials, and the reasonable expectations of improvements in efficiency in the near future.

Avoidance of the Cost-Plus Approach.—Experience indicates that contracts which provide for adjustments of the fee based upon fixed percentages of estimated costs do not effectively stimulate contractors' incentives. As a matter of fact, a contract which provides that the fixed-fee shall be adjusted proportionately to costs so that it amounts to 5 per cent of costs is merely an adaptation of a cost-plus-percentage contract.

Need of Cost Information.—The proper administration of target price contracts requires that both the contractor and the Government have a sufficient amount of cost information. If the contractor has much more cost information than the Government, he may set the target too high without the knowledge of the contracting officer. On the other hand, a contracting officer with inadequate cost information may seek to protect his position by setting targets which are too low to stimulate incentives. The use of pilot costs developed through test runs is one means of developing adequate cost information. However, a contractor who sets out to develop a high target cost may accomplish this end through the test run rather than through the cost estimate.

Audit Requirements.—In any circumstances, a target price contract which calls

[4] United States v. Bethlehem Steel Corp., 315 U. S. 289 (1942).

for cost audits maintains many of the administrative disadvantages of a cost-plus-fixed-fee contract. These include requirements of large auditing staffs, expensive accounting systems and post-audits.

General Requirements for Stimulating Incentives

The essential job of developing contractual incentives is to discover means for maintaining the natural incentives which are inherent in a profit and loss system. Businessmen have made higher profits over a period of years by cutting costs and by increasing production when the demand is great. Therefore, the development of incentives requires not the introduction of new drives but the purposeful application of existing profit motives.

A review of the types of arrangements which have been used shows that there are no magical formulas or trick contract provisions which will guarantee incentives for higher production. An understanding of the types of production and price problems which contractors have to face is much more significant than any general type of contract. Basically, efficient procurement, including a discriminating use of the various types of contract provisions, will do more to develop incentives than any single formula.

Incentives can be stimulated in individual contracts. However, a complete development requires that this general point of view should extend through all procurements, in all types of contracts, and among all Government agencies. Otherwise, the agency which develops incentives through a close pricing policy may find that contractors would rather deal with the other "more liberal" contracting officers.

When targets are used, there must be close targets, but not too low. They are useful in a practical program for improving the efficiency of all producers and for rewarding those who do a better job with the facilities they have. This means that a contractor who operates an obsolete plant efficiently should be given a greater reward than another who operates a modern plant ineffectively, even when the costs of the modern plant are lower. At the same time, the development of incentives must depend upon the possibility of developing losses as well as profits. The assurance of a return of costs will not drive business organizations to their best efforts.

A cooperative approach in contractual relationships is an integral part of an incentive system. This would include helping the contractor improve his operations through the use of comparative data. It would call for giving the contractor an opportunity to present suggestions for improved contractual and production relationships, covering such factors as the size of the order, the length of a production schedule, and simplification of the items he produces.

A complete incentive program would call for the injection of incentives into the production system at various levels. For example, salary and wage bonuses can

improve productive operations and constitute a general mechanism for strengthening profit incentives in day-to-day operations.

USE OF STATUTORY RENEGOTIATION IN FORWARD PRICING

The problems encountered in original pricing and in price adjustments made pursuant to clauses in individual contracts, on the one hand, and in statutory renegotiation under Section 403 on the other, have many points in common. Some of these points involve reward for production attainment and manufacturing efficiency; analysis of comparative costs of production; comparison of prices and price trends; and various other incidental but important contributions to the war effort. Under present procedures these two functions tackle their common problems from different points of view and therefore in the main are complementary and not overlapping. The procurement officer looks at the individual contract as one of a group of orders for the same or similar items. On the other hand, the price adjustment section considers the individual contract as one part of a company's overall business. The procurement officer is primarily concerned with prices, of which potential profits are only one element, whereas the renegotiator is primarily concerned with profits, the reasonableness of which is determined in part by the prices which the contractor has charged the Government. Renegotiation as now administered is capable of making a number of contributions to the procurement program which are unique because of the point of view from which renegotiation is conducted. Among these contributions are the following:

An Overall Look at Contracts and Operations.—The individual procurement officer can ordinarily influence at one time only a few prime contracts which may represent only a small proportion of the contractor's total business. Under renegotiation it is possible to consider all of the company's business and thus get a better perspective of the true meaning to the contractor of any one contract or group of contracts. Coordination and perspective, therefore, gained in the course of renegotiation can sometimes be a contribution to the work of the procurement officer which cannot easily be had from any other source unless he greatly enlarges his own activities. This is illustrated in those cases where prices for some items are high because of a price maintenance policy and other prices are too low except for corrective purposes. Here the price adjustment section can take an overall look and analyze the effective as well as the formal prices and make the results of its analysis available to the procurement officers.

A Coordination of Examinations of Operating and Financial Factors.—Procurement officers focusing on individual contracts have relatively little experience in and not too much opportunity for examination of operating and cost statements. Fiscal personnel can examine financial statements but have relatively little experience in or opportunity for studying operations. Production personnel examine operating factors in production but usually do not coordinate their points of view

with pertinent financial factors. Price Adjustment Sections, on the other hand, have both the experience and opportunity to look at all of these factors in their relationship to each other. Thus, unlike procurement and production personnel, Price Adjustment Sections can consider the causes of contingencies and the possibilities of rearranging them by considering the factors of risk as elements in price analysis. Charges for amortization, probable future claims because of performance guarantees, become more than a set of figures.

Comparative Analyses of Companies Within Industries or According to Products Manufactured.—Under the procedure of assigning a contractor to a single Price Adjustment Section, all prime and sub-contracts can be considered at one time—a procedure that the individual procurement officer cannot easily follow. Because of the complementary nature of the two activities, the procurement officer can secure a considerable amount of significant information from the reports developed under renegotiation or from the Price Adjustment Section. It is the only consistent source of material for use by price analysts in a comparison of components of price and costs coupled with additional knowledge of operations to permit an interpretation of their meaning. Often the most important objective is to discover why these elements differ. Conversely, this assignment system enables a company to discuss war production problems and corporate policy in one place. Because of the existence of the renegotiation procedure, many managements have seen the need for reducing prices and profits in a way which is not likely when individual transactions occupy their entire attention.

Obtaining and Using Other Existing Material.—Large duplications in work are avoided by Price Adjustment Sections acting as funnels through which pertinent information existing in the Bureau of Internal Revenue, O.P.A., S.E.C., W.P.B., and other agencies, is coordinated and made available to contracting officers. Securing this type of existing information is difficult and time-consuming if done by contracting officers directly, but it can be furnished through the Price Adjustment Sections as part of their regular procedure.

Opportunities for Improvement and Unification of Procurement Policies.—The renegotiation mechanism with its opportunities for coordinating material and points of view, with the necessity of drawing important conclusions, can affect procurement over so wide an area that it provides a practical administrative opportunity for improving procurement policies and procedures. The individual procurement officer, no matter how well he accomplishes his work, cannot look for such broad results. Large scale administration with reasonable uniformity in a somewhat technical field filled with variables is one of our major problems. Opportunity for thinking out questions together and planning their application is scarce.

Summary Approach to the Cost Elements of Price Analysis.—The functions of the cost analyst in assisting price adjustment boards or sections and of the price analyst in his relationship to procurement should be complementary, as their ap-

proach to costs is from different angles. Experience has shown that some of the help that can be given to the procurement officer, which leads quickly to a revision or confirmation of the price in a new bid proposal, is so simple that its effectiveness would not be believed if it were not for this experience. In renegotiation the cost analyst looks at the cost of sales of a contractor for the most recent closed accounting period for its entire business. These will be actual costs since the breakdown will be for a closed period. Merely placing the estimated costs presented in support of a new bid beside these experienced costs provides the procurement officer with pertinent and revealing questions. Variations may well be satisfactorily explained, but their discovery provides a speedy identification of both the reasons for and the amounts of apparent overpricing. Thus overall actual cost figures may be used as a starting point for testing the accuracy of the cost estimates in a bid proposal and may be the most practical method of identifying excessive estimates for material, labor or burden items and for discovering both the location and amounts of items included for contingencies. In addition, the renegotiation reports may provide procurement officers and price analysts with much other information such as administrative and general expenses, advertising costs, etc., and the contractor's performance record.

The discovery and measurement of manufacturing efficiency is one of the most difficult and yet important tasks with which renegotiation and procurement officials are charged. Success in this vital task is dependent upon good teamwork among those approaching the problem from different points of view—notably from the points of view of costs, engineering, and operations. Failure in any one weakens the others. A knowledge of efficiency is scarcely possible without a knowledge of how controllable items of expense have been controlled. This knowledge is linked inseparably with production accomplishment. A skillful classification and use of a breakdown of manufacturing costs therefore assume an importance in both renegotiation and procurement which should not be overlooked.

Any adequate consideration of how effective statutory renegotiation has been in the procurement pricing program would require a detailed study of: (1) the use which procurement officers have made of the information and experience gained in and the results of renegotiaton; (2) the influence which the existence of the renegotiation law and administrative policies have had upon both procurement officers and contractors, and (3) general and specific forward pricing covenants included in renegotiation agreements. Space will permit only a brief and general treatment of these subjects.

Use of Renegotiation Information and Experience.—Notwithstanding the fact that statutory renegotiation deals principally with overall data, the necessity for segregating business between that subject to renegotiation and that not so subject introduces the question of how costs were allocated. To answer this question satisfactorily for some companies requires much the same data sought by the procurement officer in dealing with cost estimates for individual contracts.

Price Adjustment Sections, in dealing with overall cost data, must inspect certain expense items and judge to what extent they can be considered as costs of war business. Decisions of this character must also be made by procurement officers. Profit margins must be related to performance, to competitive price levels, and to contribution to the war effort—considerations also to be weighed when judging prices on specific contracts.

Each topic discussed in renegotiation reports, in varying degrees when applied to individual cases, has a bearing upon the judgment of both renegotiators and procurement officers. The substance of these reports, therefore, is often a common meeting ground of the two functions and has been found useful by interested procurement officers.

The manner in which certain topics are discussed may be illustrated by the following paragraphs taken from renegotiation reports prepared by Price Adjustment Sections.

Segregation of Sales and Profits

"Material and direct labor costs are divided on the basis of actual costs for the various products. All burden items are distributed through a standard cost system in operation for a number of years. Factory burden is distributed by an application of operating departmental burden rates to direct labor hours. Administrative and selling expenses are divided on the basis of net sales."

The foregoing information is important to the Price Adjustment Sections for an understanding of the methods used in segregating sales and profits between renegotiable and non-renegotiable business. With this knowledge, the price analyst assisting the contracting officer is able to understand something of the costing method used by the contractor, and with this help he can do a better job testing cost estimates.

Extraordinary Reserves

"The company has provided from 1942 earnings special reserves totaling $540,000, for future inventory losses. No part of these reserves has been allowed in respect to renegotiable business."

The fact that the company has charged reserves of this type to its operations during 1942 is a warning to the procurement officer that the specific contract under review may be charged with a similar reserve either directly or through overhead.

Selling and Advertising Expenses

"A number of factors have required the company to maintain selling expenditures at a substantial level. (1) There is no shortage of production facilities of the type owned by the company, and it is faced with intense competition in the securing of Government contracts and subcontracts for products suitable for its equipment. Where the company formerly secured 30% to 40% of orders sought, it is now successful in only 10% of its bids; (2) the company has maintained its volume only by securing a large number of contracts and subcontracts from procurement agencies and prime contractors throughout the country; (3) the securing of these orders requires a great amount of preliminary

designing and engineering expenses which are carried out by the company's selling organization."

The foregoing discussion can assist the price analyst in understanding the nature of selling and advertising expenses allocated by the contractor to a specific contract. With this type of assistance care is more effectively taken to see that allocations of this character are made on a basis fair and reasonable to both the Government and the contractor.

Financial Data.—In the course of review of a contractor assigned for renegotiation, Price Adjustment Sections obtain from the contractor certain financial data which often can prove useful to procurement officers. These data may consist of trends in sales volume; something of the influence of changing volume upon factory overhead; the practices of the contractor in making charges for depreciation, rents and royalties, selling expenses and the like. A knowledge of these established practices enables a procurement officer more readily to understand and appraise cost breakdowns submitted in support of new bids.

Influence of Existence of the Renegotiation Law and Policies.—The influence of the existence of the renegotiation law and of the policies adopted for its administration is not simple to appraise. The difficulty of gathering evidence on a point of this kind is great in view of the many involved and interrelated factors in the picture. On the one hand, it has been argued that the renegotiation law as administered has encouraged high costs and high prices because in the last analysis the contractor came out better financially on that basis. On the other hand, it has been argued that the administration of the renegotiation law has made contractors more willing to reduce prices, since they realized they could not keep excessive profits anyway, and that this trend toward lower prices in turn has had an influence on efficiency and economy. The proponents of each point of view cite many examples to prove their case. Without attempting to review or weigh the evidence which exists on each side, it can be stated that the evidence indicating an influence for lower prices is substantial.

One of the announced policies in the administration of renegotiation is that contractors who maintain high prices and high profits will be considered as operating with less risk and will therefore be allowed smaller profits on renegotiation. Some procurement officers have noticed a marked difference in the whole tone of negotiations for new contracts by the contractors with whom they were dealing, almost immediately after this policy was announced. It is only reasonable to suppose that the influence of such policy upon contractors is substantial. This is a strategic point at which any influence is of extreme importance, because in the long run the full success of the procurement program will depend upon corporate policies which contractors adopt for themselves and in turn upon improved relationship between the contracting parties.

Forward Pricing Covenants in Renegotiation Agreements.—To the extent that renegotiation is retroactive pricing, it may apply to contracts fully or only partially

performed. To the extent that repricing of undelivered items is effected as a part of renegotiation, the repricing can apply only to the backlog of contracts yet to be performed at the time the renegotiation agreement is actually signed. The result is that there has not been and probably cannot be any very systematic pattern of forward pricing of deliveries to be made under existing contracts beginning with the close of the year to which renegotiation applies. For example, if a renegotiation agreement covering the calendar year 1942 containing a forward pricing clause, is actually signed November 1, 1943, the forward pricing clause cannot apply to deliveries made during the first ten months of the latter year. In some cases, however, the renegotiated company has agreed under such circumstances to make all future deliveries at a reduced price, and in addition has agreed to make a voluntary refund to the Government of an amount equal to the difference between the original and revised prices on deliveries made during the first ten months of the year. Due to this lag it is possible that the influence of statutory renegotiation upon deliveries made in 1944 will be greater than it has been on deliveries made in 1943.

The types of forward pricing clauses included in renegotiation agreements vary considerably depending partly on circumstances, but for the most part the following general type has been used:

"The contractor agrees to re-estimate its costs from time to time during its current fiscal year, giving consideration to its cost experience for the latest fiscal year covered by this agreement, and from time to time during the current fiscal year to adjust its prices under contracts and subcontracts subject to renegotiation under the provisions of the Act, to eliminate the accumulation during such current fiscal year of profits thereunder regarded by the contractor as excessive. The provisions of this paragraph, however, shall be without prejudice to subsequent renegotiation pursuant to the Act, relating to any fiscal year subsequent to the fiscal year covered by this agreement."

From this general type clauses vary and range to those in a few cases which are very specific, setting forth a completely revised schedule of prices for all of a contractor's war products. In some instances the clause has called for an overall percentage reduction in the contractor's prices, and in others the contractor has been left with the choice of products on which he will reduce prices.

The problem of administering these various clauses has been a difficult one. While the recapture of excessive profits lends itself to the overall approach, the adjustment in prices must ultimately occur on individual contracts. In some instances the contractor has prime contracts with several Government agencies and in addition has numerous sub-contracts. The more scattered the business of a given contractor, the harder the administrative problem becomes. No one administrative approach has been found wholly adequate. In some cases the Price Adjustment Board which conducted the renegotiation will follow up to ascertain at the right time what the contractor has done by way of complying with his covenants. In others the forward pricing clauses have been referred to the appropriate contracting officers for administration. The most difficult case arises in connection with

a sub-contractor, since such a contractor has no direct connection with any branch of the Government except the Price Adjustment Board to which it was assigned for renegotiation. In some such instances renegotiation agreements provide that the sub-contractor shall give the following kind of notice to the prime contractor in connection with price reductions:

"This reduction is the result of renegotiation pursuant to Section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942, as amended by Section 801 of the Revenue Act of 1942 and therefore, in respect of your prime contracts with the Government or subcontracts to which Section (c) of said Section 403 is applicable, under which costs will be affected by this reduction, [that] the full benefit thereof shall be passed on to the Government through equivalent aggregate price reductions or refunds under these prime contracts and subcontracts. Contracting officers of the War Department, the Navy Department and the Treasury Department and the Maritime Commission are being advised accordingly."

In some cases renegotiation has been conducted on an industry basis, enabling comparison of prices and costs not only on an overall company basis, but also on a product basis. The forward pricing clauses in these cases have probably been more successfully administered than in any others.

CONCLUSION

From time to time different panaceas are offered for all the difficulties besetting war procurement. They vary widely, often emphasizing some one approach which is predominantly of an accounting, statistical, legal, or economic nature. But such panaceas with all their formulae offer little help. The hope for a procurement program which will be a credit to the democratic and private enterprise manner of doing things rests upon a simple business use of all these approaches. They are tools to be used in a manner which will bring and keep war producers and contracting officers into contact with the facts they must deal with. It should be recognized that arbitrary authority often rests upon error and that full disclosure and good faith in negotiations are the surest guard against error.

Any system limited to a profit analysis falls short of the goal. The central objective of maximum output requires a contractor to justify his costs by production performance. Progress is lost unless both buyer and producer of war materials strongly realize that costs and possible unit output are dynamic and never static.

There are many indications that the use of the methods discussed in this article is effecting closer pricing, increased production, and improved utilization of manpower. As time goes on and both procurement officers and contractors become more proficient in the employment of these methods, it is believed that more cooperative action and generally improved contractual relationships can be expected. This in turn will result in prices which are fair and reasonable within practical limits and in more efficient and increased production. The extent to which these goals are approached or achieved will be the measure of the success of the policy. Final judgment on the overall effectiveness of the program will, however, have to await the termination of hostilities.

COVERAGE AND EXEMPTIONS[1]

W. JOHN KENNEY*

Section 403 of the Sixth Supplemental National Defense Appropiration Act, 1942, as amended,[2] contains several different methods for defining what Government contracts and subcontracts thereunder are subject to the statute. The delineation of the coverage of the statute is expressed in four ways: (1) definition (subcontract); (2) exclusion by definite tests (final payment prior to April 28, 1942, sales volume); (3) exemptions, both mandatory and discretionary; and (4) statutes of limitation

Subcontracts

Section 403, as originally enacted, made subject to renegotiation contracts with the War Department, Navy Department and Maritime Commission[3] or "any subcontract thereunder." No further explanation or definition of the word subcontract was contained in the Act.

Webster's *New International Dictionary* (1940) contains the following definitions:

subcontract, n. "A contract under, or subordinate to, a previous contract."

subcontract, v. "To contract under, or for the performance of part or all of, another contract."

subcontractor, n. "One who contracts with a contractor to perform part or all of the latter's contract."

Bouvier defines "subcontract" as follows: "A contract by one who has contracted for the performance of labor or services with a third party for the whole

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[1] The opinions expressed herein are those of the writer and are in no way to be construed as an official pronouncement of the Navy Department.

[2] 56 STAT. 245, 41 U. S. C. A. note prec. §1 (Supp. 1942). Pub. L. No. 528, 77th Cong., 2d Sess. (April 28, 1942), was the original Act. It has been amended by: Pub. L. No. 753, 77th Cong., 2d Sess. (October 21, 1942); Pub. L. No. 108, 78th Cong., 1st Sess. (July 1, 1943); Pub. L. No. 149, 78th Cong., 1st Sess. (July 14, 1943). The Revenue Bill of 1943, which has passed the House of Representatives, proposes certain changes in renegotiation law. The changes proposed in the area of exemptions are particularly significant. Since it is not known what will be the eventual disposition of the Bill and its proposals, this article does not discuss them. For a full discussion of the significance of the pending proposals, the reader is referred to the concluding article in this symposium by Jules Abels, *infra*.

[3] The Act was extended to the Treasury Department by Pub. L. No. 753, *supra* note 1, to Defense Plant Corporation, Metals Reserve Company, Defense Supplies Corporation and Rubber Reserve Company by Pub. L. No. 108, *supra* note 1 and to War Shipping Administration by Executive Order No. 9244, September 16, 1942.

or part performance of that labor or service."[4] Subcontractor is defined as "One who has entered into a contract, express or implied, for the performance of an act with the person who has already contracted for its performance."

The most closely analogous statutory provision is to be found in the Vinson-Trammel Act,[5] also designed to effectuate some control over profits, which provides that a Navy contractor under a contract for the construction of naval vessels or aircraft must agree to pay to the Treasury all profits as determined by the Treasury Department in excess of 10 per cent of the contract price of the vessels and in excess of 12 per cent of the contract price of aircraft, and "(e) to make no subcontract unless the subcontractor agrees to the foregoing conditions."

The Treasury Department has issued three sets of regulations under this statute and in Treasury Decision 4906, dated June 16, 1939,[6] defines subcontract and subcontractor as used in the regulations as follows:

"(e) 'Subcontract' means an agreement entered into by one person with another person for the construction or manufacture of a complete naval vessel or aircraft or any portion thereof, the prime contract for such vessel or aircraft or portion thereof having been entered into between a contractor and the Secretary of the Navy or his duly authorized representative.

(f) 'Subcontractor' means any person other than a contractor entering into a contract."

Up to the time of the decision of the Board of Tax Appeals in the *Aluminum Company* case,[7] there had been no decisions under the Vinson-Trammel Act as to the construction of the words "subcontract" and "subcontractor."

However, the Judge Advocate General of the Navy has written several opinions as to the application of the Vinson-Trammel Act and these opinions are helpful in determining what was the previously accepted meaning of the word "subcontract." In a letter dated September 24, 1936, to the Paraffine Companies, Inc., the Judge Advocate General said:

"Referring to your letter of August 29, 1936, stating that at times you furnish, as subcontractors, linoleums, paint and asphalt composition roofing for use in the construction of naval vessels, which material you consider as not coming within the purview of the Vinson-Trammel Act of March 27, 1934 (34 U. S. C. 496), this office is of the opinion that the above mentioned Act is applicable to all contracts and subcontracts for materials for complete naval vessels, aircraft or any portion thereof, provided the total contract or subcontract prices are in excess of $10,000.00 and that such materials have not been specifically designated by the Secretary of the Navy as being exempt as scientific equipment under the authority contained in the amendatory Act of June 25, 1936 (Public No. 804)."

In a letter to the Secretary of the Navy dated May 18, 1938, the Judge Advocate General replied to a request as to whether contracts or subcontracts for material not forming a structural portion of the complete vessel fell within the classification

[4] BOUVIER, LAW DICTIONARY, 8th ed. (1914).
[5] 48 STAT. 505 (March 27, 1934), 34 U. S. C. 1940 ed. §§496, 497.
[6] PRENTICE-HALL, GOVERNMENT CONTRACTS (1942) ¶22, 941.
[7] Aluminum Co. of America v. Commissioner Int. Rev., 47 B. T. A. 543 (1942).

of contracts or subcontracts for a "complete Naval vessel or aircraft" or any portion thereof, as provided in the Act. The Judge Advocate General cited the 1936 amendment[8] to the Act which exempted therefrom certain scientific equipment, and then went on to say:

"In view of the foregoing, the Judge Advocate General is of the opinion that materials not forming a structural portion of the complete vessel are in general subject to the above mentioned acts, and that the administrative decision as to the exceptions to such rule must be made on the basis of a submission of the conditions affecting the procurement and use of specific items."

By an opinion dated December 16, 1938, to the Secretary of the Navy, the Judge Advocate General replied to a request "as to the application of the Vinson-Trammel Act to a contract for services only for the machining of Government owned castings and as to the distinction, if any, between a contract for services for the machining of castings, including the furnishing of jigs, dies and other materials used in the machining of the castings (a contract for services and materials), and a contract for the machining of the castings alone where no materials owned or produced by the machining contractor are delivered to the Government as a part of the service contract." In this opinion he stated:

"3. In the construction of the complete ship or of any portion thereof both labor and material are used; whether the labor and material are furnished by a single contractor or by several contractors, or whether one furnishes labor or services only and another the material, does not change the obligation of a contractor or subcontractor to pay into the Treasury excess profit where the contract or subcontract involves an amount in excess of $10,000.

"4. In view of the foregoing, the Judge Advocate General is of the opinion that a contract or subcontract in excess of $10,000 for furnishing labor and material, or labor or material only, if necessary, at any stage, to produce material or equipment ultimately forming a portion of the complete Naval vessel or aircraft, is to be generally considered as coming within the scope of the above mentioned Act."

In January, 1939, the Secretary of the Navy requested the views of the Treasury Department as to the application of the Vinson-Trammel Act to a subcontract for ingots of copper and zinc to be used in the manufacture of cartridge cases. Mr. Hanes, the Acting Secretary of the Treasury, replied in part as follows:

"In the specific instance stated, it is understood that the manufacturer (the prospective bidder in this case) is regularly engaged in using ingots of zinc and copper in the manufacture of articles not made under contracts coming within the Vinson-Trammel Act. It is not clear to this Department what the terms and conditions of the commitments referred to will be. It is assumed for purposes of this consideration that the ingot zinc and copper is ordinary commercial raw zinc and copper which is in fact purchased for general use in the operations of the manufacturer and not for use exclusively in the construction and/or manufacture of articles covered by its contract under the Vinson-Trammel Act; and that the seller of the zinc and copper is not by agreement made subject to any term of condition imposed upon the manufacturer under its con-

[8] 49 STAT. 1926 (June 25, 1936).

tract with the Navy Department. The Treasury Department is of the opinion that under these circumstances such ingots of zinc and copper would not constitute portions of a complete naval vessel or aircraft within the scope of the Vinson-Trammel Act, as amended."

It is thus apparent that the term "subcontractor" in the Vinson-Trammel Act was held to include a person who furnished materials and supplies under agreement with the contractor, or a person who furnished equipment, tools or machinery (jigs, and similar equipment) which were specifically furnished for the purposes of the contract alone (*i.e.*, not for use in the general operation of the contractor's business).[9] It would not appear that in the application of the Vinson-Trammel Act any attempt was made to go beyond the first tier of subcontractors; that is, there is nothing to indicate that it was applied to sub-subcontractors.

With these opinions as a precedent, the Price Adjustment Board of the Navy Department defined subcontracts as used in Section 403 of the Renegotiation Act, as originally enacted, to include the following agreements:

(a) Any purchase order from, or any agreement with, the contractor (i) to perform all or any part of the work to be done or to supply all or any part of the aticles to be furnished, under his contract with the Government, (ii) to supply any services required directly for the production of any article or equipment covered by such contract or any portion thereof, (iii) to make or furnish any supplies, materials, articles or equipment destined to become a component part of any article or equipment covered by such contract, or (iv) to make or furnish any machinery, equipment, tools or supplies acquired by the contractor exclusively for the performance of such contract, but shall not include any agreement to supply machinery, equipment, tools or supplies or other materials or services for the general operation of the contractor's plant or business;

(b) Any purchase orders from, or any agreement with, a subcontractor who is obliggated to funish a portion of the completed articles called for under the agreement of the contractor with the Government, if such purchase order or agreement would be construed under paragraph (a) above as a subcontract if entered into with the contractor; and

(c) Any agreement of a subcontractor providing for the delivery to such subcontractor of a portion of the completed articles called for under his subcontract.

Meanwhile, the Board of Tax Appeals decided the *Aluminum Company* case,[10] and held that the term "subcontract" as used in the Vinson-Trammel Act did not include suppliers of raw materials or standard commercial articles even if incorporated in the completed article furnished under the prime contract with the Government. This decision caused a certain amount of confusion as it was contrary to the administrative interpretations already made under the Vinson-Trammel Act and to the interpretations given by both the War and Navy Departments to

[9] The Maritime Commission in issuing its regulations under the Merchant Marine Act, 1936, June 29, 1936, as amended, 52 STAT. 958, 46 U. S. C. 1940 ed. §1155(b), likewise included within the definition of subcontract any agreement with a contractor "for the manufacture or furnishing of any materials or goods * * *" and did not distinguish materialmen from other types of subcontractors. See PRENTICE-HALL, GOVERNMENT CONTRACTS (1942) ¶22, 990.

[10] *Supra* note 7. The decision of the Board of Tax Appeals has been appealed by the Commissioner to the Circuit Court of Appeals for the District of Columbia.

the term "subcontract" under the Act. As a result of this decision, contractors objected that the definition then used by both the War and Navy Departments extended the Act beyond its intended scope. It was agreed that Congress should be requested to define the term in order to eliminate any uncertainties.[11] At the hearings before the Subcommittee of the Committee on Finance, United States Senate, the War Department was initially of the opinion that in accordance with the decision in the *Aluminum Company* case, the definition of "subcontract" might properly exclude agreements for raw materials or standard commercial fabricated or semifabricated articles, and presented to the Subcommittee for consideration this definition:

"The term 'subcontract' means any purchase order or agreement to perform all or any part of the work or to make or furnish any article, required for the performance of another contract, except orders or agreements to furnish (i) raw materials, (ii) standard commercial fabricated or semifabricated articles ordinarily sold for civilian use, or (iii) articles for the general operation or maintenance of the contractor's plant. The term 'article' includes any material, part, assembly, machinery, equipment, or other personal property."[12]

Both the Maritime Commission and the Navy Department objected to this definition as being too restrictive, and the Navy Department submitted to the Subcommittee for consideration the following definition which was substantially similar to the definition it had adopted administratively:

"(5) The term 'subcontract' means (a) any purchase order or agreement (i) to perform all or any part of the work to be done or to supply all or any part of the articles to be furnished, under a contract with the Government, (ii) to supply any services required directly for the production of any article or equipment covered by such contract or any portion thereof, (iii) to make or furnish any supplies, materials, articles, or equipment specifically destined to become a component part of any article or equipment covered by such contract, or (iv) to make or furnish any material, part, assembly, machinery, equipment, or other personal property acquired by the contractor exclusively for the performance of such contract, but shall not include any agreement to supply services or any such articles for the general operation or maintenance of the contractor's plant or business in those cases where the Government is not obligated to reimburse the contractor for the cost of such articles; (b) any purchase order from, or any agreement with, a subcontractor who is obligated to furnish completed articles called for under the contract of the contractor with the Government if such purchase order or agreement would be construed under paragraph (a) above as a subcontract if entered into with the contractor; and (c) any agreement of a subcontractor providing for the delivery to such subcontractor of completed articles called for under his subcontract.

"For the purpose of subsections (d) and (e) of this section, the term 'contract' includes a subcontract and the term 'contractor' includes a subcontractor."

The distinction between the two definitions is to a certain extent explained in the letter from the Acting Secretary of the Navy to the Chairman of the Subcommittee as follows:[13]

[11] *Hearings before a Subcommittee of the Committee of Finance, Senate, on §403 of Pub. L. No. 528*, 77th Cong., 2d Sess. (Sept. 29, 30, 1942) 22. [12] *Supra* note 11, at 51. [13] *Supra* note 11, at 58.

"(a)(5) This is a new paragraph defining the term 'subcontract' and differs from the definition submitted by the War Department. The definition of the War Department excluded orders or agreements to furnish (1) raw materials, (2) standard commercial fabricated or semifabricated articles ordinarily sold for civilian use, and (3) articles for the general operation or maintenance of the contractor's plant. It is the opinion of the Navy Department that it was the intention of Congress that excessive profits should be removed from all war contracts, irrespective of whether such contracts were of the character referred to in (1) and (2) above. For this reason, the Navy Department has proposed a definition of subcontract which includes virtually all contracts made with prime contractors of the Government. It is our opinion that this definition is in accord with the suggestion of the Chairman of the Maritime Commission as contained in his letter of September 22, 1942, to Senator George."[14]

Apart from the distinction referred to in the letter from the Acting Secretary of the Navy, a further distinction in the scope of the coverage should be noted. With the exception of contracts covered by clauses (b) and (c) of the Navy Department definition and contracts "to make or furnish any supplies, materials, articles or equipment specifically destined to become a component part of any article or equipment" covered by a prime contract, the Navy Department definition is applicable only to subcontracts in the first tier, *i.e.*, subcontracts entered into directly by the prime contractor with the Government. The War Department definition, while more restricted with respect to subcontracts entered into directly with the prime contractor, in that even in the first tier it excluded "orders or agreements to furnish (i) raw materials and (ii) standard commercial fabricated or semi-fabricated articles ordinarily sold for civilian use," extended beyond the first tier to sub-subcontractors other than in the excepted area.

At this point, the Subcommittee requested the representatives of the various Departments to endeavor to agree upon a definition of the term "subcontract" that could be submitted for consideration. The Departments drafted and submitted the following definition which, without change, was enacted into the statute:

"(5) The term 'subcontract' means any purchase order or agreement to perform all or any part of the work, or to make or furnish any article, required for the performance of another contract or subcontract. The term 'article' includes any material, part, assembly, machinery, equipment, or other personal property.

"For the purposes of subsections (d) and (e) of this section, the term 'contract' includes a subcontract and the term 'Contractor' includes a subcontractor."[15]

Examination of this definition makes it obvious that both the War and the Navy Departments had receded somewhat from their positions; the definition is of sufficient scope to include raw materials or any other type of materials and to go beyond the first tier of subcontractors. This is supported by the fact that in order to exempt raw materials, it was found necessary to incorporate Subsection (i)(1)(ii) in the Act.[16]

[14] *Ibid.*

[15] Section 801, Pub. L. No. 753, 77th Cong., 2d Sess., approved Oct. 21, 1942.

[16] *Supra* note 11, at 147.

The legislative history thus clearly indicates the intention of Congress to give the term "subcontract" a broad meaning and not the restrictive one given in the *Aluminum Company* case or suggested by the War Department. There are, however, two qualifications to the coverage of subcontracts by this amendment in that (1) the subcontract must be for work or an article "required for the performance of any other contract or subcontract" and (2) article is defined to include "any material, part, assembly, machinery, equipment or other personal property." Under the first qualification of requirement for performance, contracts for such articles as fuel, light, power, and general office equipment could be included. While general factory supplies may be "required for the performance" in the strictest sense, they contribute only indirectly to the actual manufacturing process, and contracts therefor should not be included in the definition of subcontract. No one indicated to the Subcommittee any desire to include such contracts[17] and the Departments have so interpreted the Act to exclude them.[18] The second qualification excludes from the purview of the statute subcontracts for real property. The remoteness of a subcontract for real property from the article eventually purchased by the Government probably affords a sound basis for this exclusion. The test as to whether a subcontract involves "real property" should be whether it is for the purchase or sale of real property as such. The mere fact that the subject matter of the contract may subsequently be affixed to real property would not appear to be sufficient to exempt it from the provisions of the statute. Thus, a contract for the sale of bricks which are to be incorporated in a furnace required for the performance of the contract with the Government should be subject to the provisions of the statute. The Departments have adopted an interpretation which excludes a contract with a contractor or subcontractor for the construction of an open hearth furnace but includes such contract for the installation of machinery or equipment to be used in the processing of an end product or of an article incorporated in an end product, even though after construction or installation both become real property.[19] The line of demarcation is perhaps justified in view of the inclusion of the words "machinery" and "equipment" in the definition of the term "article" in the statute.

Brokers' and Representatives' Fees

The agitation against contingent fee brokers resulted in a further extension of the term "subcontractor" by Public Law 149, 78th Congress approved July 14,

[17] *Hearings before the Committee on Naval Affairs pursuant to H. Res. 30*, 78th Cong., 1st Sess. (1943) Vol. 2, 1282 (hearings on investigation of renegotiation of war contracts).

[18] The JOINT STATEMENT BY THE WAR, NAVY AND TREASURY DEPARTMENTS AND THE MARITIME COMMISSION OF PURPOSES, PRINCIPLES, POLICIES AND INTERPRETATIONS (March 31, 1943) at page 10 interprets subcontract "to include contracts with contractors and subcontractors (a) for the sale or processing of an end product or an article incorporated therein, (b) for the sale of machinery or equipment, used in the processing of an end product, or an article incorporated in an end product, (c) for the sale of component parts of or subassemblies for such machinery or equipment, and (d) for the performance of personal services required for the contracts and subcontracts included in (a), (b), and (c)."

[19] Supplemental Interpretation (July 10, 1943) to the JOINT STATEMENT, *supra* note 18.

1943. The problem of unconscionable fees in the procuring of Government contracts has existed in every war in which this country has been engaged. The camp followers of war procurement arrive long before the commencement of hostilities. The policy against the payment of unconscionable fees, particularly during time of war, to agents specializing in the procurement of Government contracts was first enunciated during the Civil War by the Supreme Court of the United States.[20] The Supreme Court has consistently held that contracts calling for payment of compensation to an agent for the use of improper influence upon Government officials to obtain Government contracts are contrary to public policy and therefore unenforceable.[21] A contract, contemplating no improper influence, to pay a commission or other fee to an ordinary salesman or agent for securing a Government contract was probably enforceable.[22]

By Order of June 10, 1927, the President required the insertion of the following warranty in all subsequent Government contracts:

"The contractor warrants that he has not employed any persons to solicit or secure this contract upon any agreement for a commission, percentage, brokerage, or contingent fee. Breach of this warranty shall give the Government the right to annul the contract, or, in its discretion, to deduct from the contract price or consideration the amount of such commission, percentage, brokerage, or contingent fees. This warranty shall not apply to commissions payable by contractors upon contracts or sales secured or made through bona fide established commercial or selling agencies maintained by the contractor for the purpose of securing business."

This order has remained in effect since this date.[23] It is apparent that the exception contained in the third sentence of the warranty is extremely broad. It has never been construed by the courts.[24] Government procurement officers have been reluctant to adopt a strict construction of the exceptions, because to do so would penalize companies employing agents who had performed useful and valuable services, and in any event the enforcement of the warranty would strike solely at the principal, rather than the agent, and would afford the principal no protection against court action by the agent to recover the amount of compensation agreed upon.[25]

The tremendous increase in Government procurement caused by the present war again brought this problem to public notice. During the summer of 1942, the House Naval Affairs Committee conducted a series of hearings to investigate excessive contingent fees and commissions chargeable to the cost of the war effort.

[20] Tool Company v. Norris, 69 U. S. (2 Wall.) 45 (1864).

[21] Oscanyan v. Arms Co., 103 U. S. 261 (1880); Crocker v. United States, 240 U. S. 74 (1916); Steele v. Drummond, 275 U. S. 203 (1927).

[22] See Oscanyan v. Arms Co., 103 U. S. 261, 275-276 (1880); Hazelton v. Sheckells, 202 U. S. 71 (1906) *semble;* Valdes v. Larrinaga, 233 U. S. 705 (1914) *semble;* Steele v. Drummond, 275 U. S. 199 (1927) *semble*. The *Tool Company* case, *supra* note 20, could probably be distinguished.

[23] For a complete history of the development of the "warranty clause" see *Hearings before the Committee on Naval Affairs on H. Res. 30*, 78th Cong., 1st Sess. (1943), Vol. I, 380-385.

[24] United States v. Buckley, 49 F. Supp. 993 (Dist. Col. 1943).

[25] Bradford v. Durkee Marine Products Corp., 40 N. Y. S. (2d) 448 (Sup. Ct. 1943).

These hearings disclosed that certain individuals and firms being paid on a commission basis were receiving enormous sums in connection with the procurement of Government contracts, in some cases from $500,000 to $1,000,000 per year. At the close of the hearings, the Committee reported out H. R. 7304, a bill which in effect made invalid and unenforceable any agreement to pay a commission or contingent fee to any third party for securing a Government contract. The bill imposed criminal penalties upon both agent and principal for entering into such a contract. It was passed by the House on July 20, 1942, and sent to the Senate where it never was voted out of the Committee on Naval Affairs. There were several defects in the bill; it appeared overly stringent in that it disallowed any compensation whatsoever to commission agents who, in many cases, performed a useful and valuable function in bringing together small manufacturing concerns and Government procurement needs; it did not reach excessive amounts paid to manufacturers' representatives on a salary or other fixed basis; and finally, it did not reach compensation paid to representatives of subcontractors.

In March and April, 1943, the House Naval Affairs Committee conducted further hearings in connection with the problem and at the conclusion of the hearings, the Committee reported out H. R. 1900, which passed both the House and the Senate unanimously and was approved by the President on July 14, 1943, as Public Law 149, 78th Congress.

In general, Public Law 149 is designed to keep payments to manufacturers' representatives within reasonable bounds, rather than to forbid the payment of compensation to any class of persons for procuring Government contracts or subcontracts. It accomplishes this purpose by expanding the definition of "subcontract" in the act to embrace within the scope of renegotiation the contracts or arrangements between manufacturers' representatives and their principals. The first section of Public Law 149 effects this expansion as follows:

". . . the first sentence of section 403 (a)(5) of the Sixth Supplemental National Defense Appropriation Act, 1942, as amended, is amended to read as follows: 'The term "subcontract" means (i) any purchase order or agreement to perform all or any part of the work, or to make or furnish any article, required for the performance of any other contract or subcontract or (ii) any contract or arrangement (other than a contract or arrangement between two contracting parties, one of which parties is found by the Secretary to be a bona fide executive officer, partner, or full-time employee of the other contracting party), (A) any amount payable under which is contingent upon the procurement of a contract contracts with a Department or of a subcontract or subcontracts thereunder, or determined with reference to the amount of such a contract or subcontract or such contracts or subcontracts, or (B) under which any part of the services performed or to be performed consists of the soliciting, attempting to procure, or procuring a contract or contracts wtih a Department or a subcontract or subcontracts thereunder: Provided, that nothing in this sentence shall be construed (1) to affect in any way the validity or construction of provisions in any contract with a Department or any subcontracts thereunder, heretofore at any time or hereafter made, prohibiting the payment of contingent fees or commissions; or (2) to restrict in any way the authority of

the Secretary to determine the nature or amount of selling expenses under subcontracts as defined in (ii) herein, as a proper element of the contract price or as reimbursable item of cost, under a contract with a Department or a subcontract thereunder.' "

Subdivision (i) above is a repetition of the previously existing definition of "subcontract"; the remainder of Section 403(a)(5) above is new. In order to include within the scope of renegotiation all types of arrangements between representatives and principals. Subdivision (ii) has a dual approach. Subdivision (ii)(A) defines the representatives' contracts embraced by this statute by describing the nature of the compensation to be paid thereunder. In general, it subjects to renegotiation any contract calling for compensation contingent upon the procurement of a prime Government contract or subcontract thereunder or the amount of compensation under which is determined with reference to the amount of such prime contract or subcontract. This portion of the definition regards the nature of the services which the representative has contracted to perform for his principal. Contracts for engineering services and even legal services are therefore subject to renegotiation if the compensation called for thereunder is in any way contingent upon the procurement of a prime contract or subcontract. Subdivision (ii)(B), on the other hand, approaches the problem from the standpoint of the description of the services rendered without regard to the manner of compensation. Any contract calling for compensation in return for solicitation of a prime Government contract or subcontract is made subject to renegotiation. Thus excessive salaries or fixed fees paid for soliciting prime contracts or subcontracts may be renegotiated.

Proviso (1) in the above section is self-explanatory. Proviso (2) reserves in the respective Government departments their pre-existing authority and discretion to refuse to enter into any contract which includes excessive compensation to a sales representative as part of the contract price, regardless of the fact that such compensation may later be refunded to the Government in whole or in part in the renegotiation of the representative's profits.

Sections (2) and (3) of Public Law 149 amend the act so as to except from renegotiation those representatives whose aggregate compensation from all their principals does not exceed $25,000 per year, as contrasted with the $100,000 exception applicable to the sales of contractors and subcontractors as originally defined in the basic act.

Section (5) of Public Law 149 declares the effective date of its provisions to be April 28, 1942 (the effective date of the basic Act).

Exemptions

There are various exclusions and exemptions from renegotiation provided for in the Act: (1) Subsection (c)(6)(i) excludes contracts and subcontracts on which final payment "was made prior to April 28, 1942"; (2) Subsection (c)(6)(iii) excludes contractors and subcontractors whose sales otherwise subject to the Act for

the fiscal year under consideration do not exceed $100,000,[26] except solicitors of Government business defined in Subsection (a)(5)(ii), for whom the limit is $25,000 of sales in the fiscal year; (3) Subsection (i)(1) provides that the Act shall not apply to—

"(i) any contract by a Department with any other department, bureau, agency, or governmental corporation of the United States or with any Territory, possession, or State or any agency thereof or with any foreign government or any agency thereof or

"(ii) any contract or subcontract for the product of a mine, oil or gas well, or other mineral or natural deposit, or timber, which has not been processed, refined, or treated beyond the first form or state suitable for industrial use; and the Secretaries are authorized by joint regulation, to define, interpret, and apply this exemption"; and

(4) Subsection (1)(2) grants discretionary power in each Secretary to exempt (a) contracts or subcontracts which are to be performed outside the territorial limits of the United States or Alaska, (b) contracts or subcontracts where profits can initially be determined with reasonable certainty and (c) portions of contracts or subcontracts or performance thereof for specified periods if the provisions of the contract are otherwise adequate to prevent excessive profits.[27]

The exclusion first above referred to raises the legal question as to whether a series of transactions constitute one contract or several contracts. The question is most frequently encountered in cases involving increases in quantities, orders under option agreements, work performed under repair contracts which specify in general the conditions for performing work under job orders, and the furnishing of material under requirement contracts. The test is the severability of the transactions not the divisibility of the contract; did the parties give a single assent to a whole transaction or did they assent separately to several separate transactions? The divisibility of performance does not of necessity connote separate contracts. In the strictest sense, a divisible contract is always one contract, and not several contracts.[28] Under this test, a valid contract covering work performed and material furnished at various times, even though the contract does not contain all of the details of performance, would constitute a single contract—divisible, it is true, as to performance, but *not* separable; and all profits under such contract would therefore be subject to renegotiation if final payment thereupon was made subsequent to April 27, 1942. The fact that one or both of the parties could under certain conditions refuse to perform or that the consideration is not definitely stated should not alter this rule.[29]

[26] H. R. 2324, 78th Congress, introduced by Representative Doughton on March 29, 1943, and the Revenue Act of 1943, which has passed the House of Representatives, propose to increase this figure to $500,000.

[27] S. 1366, 78th Congress, introduced by Senator Hatch on September 21, 1943, if enacted, would provide that profits shall not be deemed excessive if they amount before the deduction of Federal income and excess-profits taxes to 8 per centum or less of sales prices for the fiscal year under consideration and sales for such period are not more than three times the average total sales during the base period from 1936 to 1939 inclusive.

[28] 3 WILLISTON, CONTRACTS (Rev. ed. 1936) §861.

[29] 3 WILLISTON, CONTRACTS (Rev. ed. 1936) §862.

The exemptions afforded in Subsections (c)(6)(iii) and (i)(1)(i) are self-explanatory. The exemption in (i)(1)(ii) is the so-called raw material exemption, which was added to the Act by Section 801 or the Revenue Act of 1942. The legislative record is somewhat meager as to precisely what was intended to be covered by the language employed. It does, however, appear that none of the Departments wished the power to renegotiate contracts or subcontracts for raw materials and that certain members of the Senate Finance Subcommittee felt that the various Price Adjustment Boards could not adequately consider in renegotiation the problems involved in vanishing assets, the production of which was a drain on the capital account of the producer.[30] The broader definition of the term "subcontractor," recommended to the Subcommittee, made necessary a specific exemption to provide a cut off for subcontracts for raw materials at some point this side of the mines.[31] A reasonable conception of raw materials is that they constitute the product of a mine, oil or gas well or other mineral or natural deposit, which has been extracted from the earth and then turned over for manufacturing use. While depletion was a phase of the problem to be covered,[32] the language employed clearly indicates that it was not the sole factor. In addition, there are certain "materials" such as copper for which incentive prices had been established to encourage their extraction from the earth.[33] To make contracts or subcontracts for such products subject to renegotiation would tend to nullify the incentive. To the draftsmen of this subsection, the language of Subsection (i)(1)(ii) met the problem in general although its application to specific situations may be in many instances difficult. The test of exemption of a raw material is the point at which the extracting industry customarily disperses the product in subtsantial quantities in the channels of industry other than that of extraction. Under this test, the industry of origin may generally perform certain processing, refining or treatment of the product so that different analogous products may be exempted at different stages of the processing, refining or treating. For example, aluminum ingots or pigs, and copper ingots, rather than bauxite or copper concentrates, are the customary form in which the trade acquires this raw material from the extracting industry, whereas crude oil is the form in which the oil refining industry normally acquires that raw material for industrial use. The language of the subsection requires that the product, to retain its exemption, must not have been "processed, refined, or treated beyond the first form or state suitable for industrial use." No implication should be drawn from this language that some processing, refining, or treatment is required in order to progress beyond the point of exemption. Clearly the oil refining industry is an industry, so that the utilization of crude oil by that industry is an industrial use of the product of an oil well, notwithstanding the fact that there has

[30] *Supra* note 11, at 128. [31] *Supra* note 11, at 147. [32] *Supra* note 11, at 128.

[33] The writer participated in the drafting of this subsection for the consideration of the Committee, and in analyzing the problems for which a solution was sought, does, to a certain extent, go beyond the legislative record.

been no refining up to that point. This is the rationale of the joint regulation promulgated as of February 1, 1943 by the Secretaries.[34]

Subsection (i)(2)[35] confers discretion on the Secretary to exempt under circumstances where it was felt that renegotiation would not further the general purposes of the Act. To require a native of Iran constructing in Iran a railroad or other works necessary for the prosecution of the war to renegotiate his contracts is an unnecessary extension of the extraterritorial powers of the United States, and to enforce such action might interfere with the prosecution of the war. Accordingly, such contracts may be exempted under Subsection (i)(2)(i). A similar situation might not arise in the construction of a naval base in the Caribbean, and therefore the power granted to the Secretary is discretionary. The class of contracts enumerated in (i)(2)(ii) is not definitive or all-inclusive, but merely indicative of the general class or type which may be exempted.[36] The sole test is whether in the opinion of the Secretary profits can be determined with reasonable certainty when the contract price is established. Acting under this subsection the Secretaries of War and the Navy have exempted contracts and subcontracts for the purchase or lease of any interest in real property, for certain food products, with public utilities when made at public rates or charges, fixed, approved or subject to regulation by a public regulatory body, and for commodities, the minimum price for the sale of which has been fixed by a public regulatory body.[37] The last provision of Subsection (i)(2)(ii) was added in order to extend the discretion of the Secretary in making firm prices for limited periods and to permit the exemption of so-called "target price" contracts.[38]

There are four provisions of the Act that provide periods of limitations for the commencement of renegotiation proceedings:

[34] JOINT STATEMENT, *supra* note 18, at 12, 13. H. R. 3015, 78th Congress, has been introduced by Representative Price on June 21, 1943, and, if enacted into legislation would permit the Secretaries to exempt raw materials by joint regulation, at any stage of processing, refining or treating.

[35] Subsection (i)(2) provides:

"(2) The Secretary of a Department is authorized, in his discretion, to exempt from some or all of the provisions of this section—

(i) Any contract or subcontract to be performed outside of the territorial limits of the continental United States or in Alaska;

(ii) any contracts or subcontracts under which, in the opinion of the Secretary, the profits can be determined with reasonable certainty when the contract price is established, such as certain classes of agreements for personal services, for the purchase of real property, perishable goods, or commodities the minimum price for the sale of which has been fixed by a public regulatory body, of leases and license agreements, and of agreements where the period of performance under such contract or subcontract will not be in excess of thirty days; and

(iii) a portion of any contract or subcontract or performance thereunder during a specified period or periods, if in the opinion of the Secretary, the provisions of the contract are otherwise adequate to prevent excessive profits.

The Secretary may so exempt contracts and subcontracts both individually and by general classes or types."

[36] See Springer v. Philippine Islands, 277 U. S. 189, 206 (1928) for statement of pertinent exception to the *expressio unius exclusio alterius* rule.

[37] The Bituminous Coal Act of 1937, 50 STAT. 77, 15 U. S. C. 1940 ed., §833, gives the Commission power to prescribe minimum and maximum prices.

[38] *Supra* note 11, at 56, 58.

(1), Subsection (c)(6) specifies that no renegotiation shall be commenced more than one year after the close of the fiscal year of the contractor or subcontractor within which completion or termination of the contract or subcontract, as determined by the Secretary, occurs. It should be noted that this provision refers to completion or termination of the contract rather than the time of payment provided for in Subsection (c)(6)(i). For the purposes of this subsection the completion of a contract occurs at the time of final delivery or acceptance under the contract, rather than at the time of final payment; the fact that a contractor may still have certain obligations under guarantees of performance or the fact that there may be unliquidated items outstanding does not extend the time of completion beyond the date of final delivery or acceptance.[89] The date of termination would be that date on which all work under the contract has been terminated. Renegotiation commences on the date set for the initial conference unless otherwise agreed.

(2), Subsection (b) authorizes the parties to agree upon the period or periods when or within which renegotiations may be had. This agreement may lengthen or shorten the periods of limitations otherwise provided for in the Act.

(3), Subsection (c)(5) provides that, if a contractor or subcontractor files a statement of costs of production for prior fiscal periods in form prescribed by the Secretaries, no renegotiation shall be required for the fiscal period covered by the statement unless the Secretary shall within one year after the date of filing give written notice of a time and place for an initial conference to be held within sixty days thereafter.

(4), Subsection (h) provides that the Act shall remain in force during the continuance of the present war and for three years after the termination of the war, but no court proceedings brought under the Act shall abate by reason of the termination of the Act. The termination of the war would be the date of the signing of the final treaty of peace and not the cessation of hostilities. If three years after that date renegotiations have not been completed, all further authority to proceed under the Act, except for court proceedings instituted would be gone. In view of the requirement in the Act for the insertion of a renegotiation clause in contracts and subcontracts subject to the Act, the question is raised as to the power to renegotiate after this date under the renegotiation clause rather than under the Act. Congress in requiring the inclusion of the clause clearly intended to give some potency to the clause apart from the Act. A fairer result might be to terminate renegotiations for all contracts at the same time irrespective of the inclusion of the renegotiation clause.

[89] *Supra* note 18, at 16.

RENEGOTIATION STANDARDS AND PRACTICES

CARMAN G. BLOUGH*

[As this article goes to press, there is pending before Congress the Revenue Bill of 1943 containing provisions for amending the existing Renegotiation Act. This Bill has passed the House of Representatives, has been amended in certain significant aspects by the Senate Finance Committee, but has not yet been introduced on the Senate floor. In view of the discussion contained in the concluding article of this symposium and of the uncertainty of the adoption of the various items constituting the amendment proposals, the writer has decided not to comment on any particular portion of the Bill as it now stands.]

Since April, 1942, thousands of manufacturers have undergone examinations by and conferred with government representatives pursuant to the requirements of the Renegotiation Act (Sec. 403 of the Sixth Supplemental National Defense Appropriation Act, 1942, approved April 28, 1942, as amended).[1] This Act authorizes the renegotiation of contracts not exempt therefrom under its terms, to eliminate excessive profits from production under contracts with the War Department, the Navy Department, the Treasury Department, the Maritime Commission, War Shipping Administration, Defense Plant Corporation, Metals Reserve Company, Defense Supplies Corporation, and Rubber Reserve Company, respectively. Within those agencies Price Adjustment Boards, as well as Regional Boards or "Sections" in some agencies, have been set up to carry out the provisions of the Act. The term "Board" or "Section" when used in this article refers to one of the departmental price adjustment boards or their regional organizations, as the case may be.[2]

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[1] 56 STAT. 245, 41 U. S. C. A. note prec. §1 (Supp. 1942). The original Act was contained in Pub. L. No. 528, 77th Cong., 2d Sess. (April 28, 1942), §403. It has been amended by: Pub. L. No. 753, 77th Cong., 2d Sess. (Oct. 21, 1942); Pub. L. No. 108, 78th Cong., 1st Sess. (July 1, 1943); Pub. L. No. 149, 78th Cong., 1st Sess. (July 14, 1943).

[2] For full discussion of the administrative machinery and organization for handling renegotiation in the various agencies, see, in this symposium, Boyd, *Administrative Machinery and Procedures for Renegotiation, infra* p. 309.

In September, 1943, by joint action of the interested agencies, a "Joint Price Adjustment Board" was created to which were delegated certain over-all coordinative functions, including the formulation of policies, principles and interpretations binding upon all the interested agencies.

The Boards early adopted the principle of renegotiation upon the basis of contractor operations for a fiscal period, rather than to consider each contract specifically, except with respect to cost-plus-fixed-fee contracts. They further agreed that for any fiscal year a contractor would be subject to renegotiation only once, and then by the Board or the Department most heavily interested in his production, whether from prime or subcontracts. On this basis, of the companies[8] subject to renegotiation approximately 65% are cases for the War Department Price Adjustment Board, 20% for the Navy Department Board, with the remaining 15% distributed among the other four boards.

NATURE OF RENEGOTIATION

The accumulation, analysis and discussion of a contractor's financial and operating data are the three elements of renegotiation. To many people negotiation is a high sounding word for a process of trading, a "dicker," which is expected to result in a compromise; the seller tries to get for the object of sale more than he is willing to accept, the buyer offers a price which is less than he is willing to pay; each moves gradually from his original position until agreement on a price agreeable to both, as a basis for sale, is reached. Although a negotiation may degenerate into a "dicker" or "horsetrade," fundamentally it is an orderly procedure which involves discussions between buyer and seller to evaluate correctly, from an analysis of all determinable factors, the object of sale, with a view to setting a

[8] This brings up the question of affiliated companies. When two or more companies constitute an "affiliated group," as defined by Section 141(d) of the Internal Revenue Code, they will ordinarily be renegotiated on a consolidated basis. This section reads in part as follows:

"(d) Definition of 'Affiliated Group.' As used in this section, an 'affiliated group' means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

"(1) Stock possessing at least 95 per centum of the voting power of all classes of stock and at least 95 per centum of each class of the non-voting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

"(2) The common parent corporation owns directly stock possessing at least 95 per centum of the voting power of all classes of stock and at least 95 per centum of each class of the non-voting stock of at least one of the other includible corporations.

"As used in this subsection, the term 'stock' does not include non-voting stock which is limited and preferred as to dividends."

Under such circumstances all companies in the group will usually be assigned to the same Board or Section for consolidated treatment. When two or more companies do not meet the terms of the above definitions, but are nevertheless so related, both with respect to stock ownership and management control, that they customarily report their earnings and financial condition on a consolidated basis, they may be renegotiated on a consolidated basis, also. In any event, all companies that are related through common ownership, through a parent-subsidiary affiliation or through common management are usually assigned to the same group for renegotiation, in order that the factors inherent in their relationship may be properly evaluated. There have been a few outstanding exceptions, where the business of a subsidiary is so different from that of its parent that consolidation is not deemed proper, in which case they have been assigned to different departments.

price agreeable to the buyer, that will fairly compensate the seller for his services in producing the item.

The exigencies of the war necessitated the substitution of negotiation for normal competitive procedures in the procurement of practically everything required for its prosecution. The unanticipated profits from war production at prices negotiated in good faith but in ignorance of costs obtainable with respect to articles never before manufactured and from others produced in theretofore unheard-of quantities, compelled the passage of the "Renegotiation Act," whereby the negotiation could be completed through *re*negotiation, and as the result of a discussion of all the determinable factors involved therein, based on an analysis of known facts, accumulated through experience in war production, the war goods could be delivered, properly priced. While the scope of renegotiation, as originally contemplated, may have undergone changes in practice, nevertheless, without such a procedure many contractors would realize profits so excessive as to create conditions in our economy, the far reaching disastrous effects of which would endanger the very things for which this nation is fighting.

The question is sometimes raised as to whether the work of the Price Adjustment Boards is not similar to that of commissions responsible for fixing or approving public utility rates. To be sure, the function of each involves the pricing of the output to leave a fair and reasonable profit. At that point, however, the similarity ends. The determination of fair public utility rates, under prevailing legal theories, centers around the company's rate base, which involves valuation of certain assets in terms of original cost, cost of reproduction, etc. Public utility commissions are expected to see that the rates they allow provide a fair return to investors as well as fair service charges to customers, but their concern is for a long range rather than a short range result. The Price Adjustment Boards, on the other hand, are concerned with the problems of production of a large variety of types of business operating under abnormal conditions. The relation of a company's profits to its gross assets and to its net worth are only a few of the factors which the Price Adjustment Boards must consider. Short term factors are more important in war production than long term factors. Furthermore, even if capital were the major factor in determining fair war profits, to secure adequate appraisals of contractors' assets in order to place their respective capitals on a comparable basis, would be, at least under current conditions, an impossible task. The Boards seek to determine a fair compensation to a contractor for the war production job that he has done in the light of the problems with which he has been faced in its performance, and after an analysis of the contractors' financial data of a type that is usually found to be of assistance to procurement officers in setting prices for future orders. Too many important war production jobs worthy of substantial compensation are done by companies having very little capital, to limit them to profits determined on a basis comparable to that followed in fixing the rates of utilities. The incentives to full war production call for a compensation for out-

standing immediate contributions and not particularly for encouragement to long term investment as is the case in fixing rates for utility services.

INITIAL STEPS AND REQUIRED DATA

The procedure of renegotiation with respect to a specific contractor therefore begins with a search for facts regarding his operations, costs, financial condition, performance and a variety of other factors which bear on the prices of his war products and the profits from his war business. The responsibility for obtaining and analyzing the financial data lies with a cost analyst identified with the Board or Section to which the contractor is assigned. The cost analyst is not expected to audit the contractor's accounts. He usually finds it necessary, however, to spend a day or two at the contractor's plant in order to explain what data are required and how they shall be obtained and presented. It is helpful if he can go through the plant, obtain impressions of how it operates, the types of equipment used, the types of employees required, the nature of the products manufactured and so on. In this initial discussion with the contractor and in the survey of the plant, the negotiator or general analyst charged with the case may accompany him.

While the forms in which they are submitted are not uniform, all the Boards seek substantially the same types of information and data from the contractors assigned to them.

These include the results of operations for the latest closed fiscal year, separated as to renegotiable and non-renegotiable business as defined under the Act, and itemized with respect to sales, costs, expenses and profit applicable to *fixed price* business, shown in detail or supplemented by schedules of cost of sales, selling and advertising expenses, general and administrative expenses and other applicable income and deductions. Analysis of depreciation charges included (whether or not specified) in any of the above items or schedules, with respect to their normality, acceleration and relation to idle plant, is requested, as well as information relative to such miscellany as amortization of emergency facilities, executive salaries, the approximate cost of work subcontracted and a segregation of renegotiable sales between prime and sub-contracts. The net fees earned under cost-plus-fixed-fee contracts, applicable, respectively, to both renegotiable and non-renegotiable business, are not to be confused with income from fixed price business, though included in a contractor's income statement. The costs and billings applicable to cost-plus-a-fixed-fee contracts are wanted, but may be shown in a separate schedule.

In addition, in anticipation of this first renegotiation, a contractor is generally asked to furnish his renegotiating Board with a comparative operating statement, in columnar arrangement, for the six years immediately preceding the year under review, comparable as to titles with the corresponding statement for such year.

Statistical data related to the financial figures, an explanation of the methods employed to obtain the segregation of renegotiable and non-renegotiable business,

and comments relative to a variety of matters of significance to a Board in its determination of a contractor's excessive profits, are also requested.

EXEMPTIONS AND DETERMINATION OF RENEGOTIABLE BUSINESS

The determination of the amount of a contractor's renegotiable business and the costs and expenses applicable thereto, is his most difficult task in the fact finding procedures of renegotiation. The difficulty is less formidable where the contractor has directly contracted with the Government than in those transactions with respect to which the contractor is a "sub-contractor" within the renegotiation statute, as that term is currently interpreted administratively. As in "prime contracts," the main question in determination of renegotiable business is whether the contract, although with one of the governmental agencies included in the Act,[4] is nevertheless exempt by the specific statutory exemption provisions and the administrative practice under the discretionary exemptions. The Act, as Mr. Kenney points out in his article in this symposium, contains a number of exemptions.[5] The following five types of business may be said to be exempted directly or indirectly by the Act: (1) all contracts which are not with one of the renegotiating departments, or sub-contracts thereunder; (2) contracts completed and fully paid for prior to April 28, 1942; (3) contracts or sub-contracts for the product of a mine, oil or gas well, or other mineral or natural deposit, or timber, which has not been processed, refined or treated beyond the first form or state suitable for industrial use; (4) intra-federal Government contracts; (5) contracts of Renegotiating Departments with extra-federal Governments or agencies thereof.

In addition, the Act authorizes the Secretary of a Department, in his discretion, to exempt certain types of contracts.[6] As to his *prime* contracts, a contractor should have little difficulty in determining what part of his sales during any fiscal year are

[4] Contracts with government Departments and agencies not named in the Act (except War Shipping Administration) and subcontracts thereunder, or transactions in products the end use of which is not related to a prime contract with one of such Departments, are not subject to renegotiation. Thus, contracts with the Post Office Department for mail boxes would not be subject to renegotiation, and the companies that furnished the steel and the locks for such boxes would be exempt from renegotiation with respect to such sales. Contracts with War Shipping Administration and subcontracts thereunder are subject to renegotiation due to the transfer of certain responsibilities to it by the President under the First War Powers Act, from the Maritime Commission.

Although all contracts with the Treasury Department appear to be within the purview of the Act, unless of a type otherwise specifically exempt, the Treasury Department Price Adjustment Board has taken the position that it will renegotitate only those contracts which it considers to be strictly war contracts such as purchases for Lend-Lease, of strategic and critical materials, or suppliers for refugee relief under the Red Cross program, etc.

Accordingly, contracts of the Procurement Division of the Treasury Department under its General Schedule of Supply Contracts are not subject to renegotiation unless of such war time nature. However, purchase orders issued by any other Department named in the Renegotiation Act, under the General Schedule, *are* subject to renegotiation.

[5] Because a discussion of renegotiation standards and practices inevitably involves a consideration of the exemptions, the writer deems it advisable to comment briefly upon certain aspects of exemption at the risk of a slight duplication with some of the material in Kenney, *Coverage and Exemptions, supra* pp. 263 ff. This article, however, does not purport to present an over-all discussion of exemptions, and for a general discussion of the subject, the reader is referred to Mr. Kenney's article.

[6] See, in this symposium, Kenney, *Coverage and Exemptions, supra* p. 263, at 272 ff.

under those contracts and of segregating the sales under non-renegotiable prime contracts from those under renegotiable prime contracts.

With respect to sub-contracts, however, the determination of the renegotiable business may be far from simple. This results from the application of the statutory term "sub-contract," as administratively interpreted, to the complexity of the distributive processes of industry, and the difficulty of tracing products into the crucial end product subject to renegotiation. A sub-contractor—a manufacturer of, or dealer in products sold to other manufacturers—may have to apply several tests to determine what proportion of his sales are war business. Under the interpretation which the agencies have adopted, the *general* test for determining a renegotiable "sub-contract" lies in this question: Will the price of the product sold become a part of the cost of something to be delivered to a department named in the Act? In the statute, "sub-contract" is defined to include "any purchase order or agreement to perform all or any part of the work, or to make or furnish any article required for the performance of any other contract or sub-contract."[7] This has been administratively interpreted to include: the sale, furnishing or installation of machinery, equipment, or materials used in the processing of an end product, or of an article incorporated therein; the sale, furnishing or installation of machinery used in processing of other machinery to be used in the processing of an end product or of an article incorporated therein; the sale, furnishing or installation of component parts (including materials and ingredients) of, or sub-assemblies for, such machinery, equipment, and materials, and the performance of services[8] directly required for the performance of such contracts or sub-contracts.

Under the foregoing interpretation sales of end products and of everything which in any way contributes directly to the actual production of an end product—or one of its components—purchased by a renegotiating Department, except items used for general plant maintenance (including safety equipment and clothing, and fuel and equipment to produce light, heat and power), and for general office maintenance (including office machinery and supplies), are renegotiable. Thus, sales of steel ingots, which are processed into rods, which are drawn into wire, from which are made screws used in the manufacture of a machine tool which is used in the manufacture of a part of a motor which is installed in a truck sold to the Army, are subject to renegotiation. Likewise the sales of each processor or manufacturer in the chain, insofar as they contribute to the completion of such truck, are subject to renegotiation. But it is not likely that all of the screws produced from the steel ingot figured in war production. Some of them undoubtedly reached retail hardware stores through regular channels of distribution, and were sold to individual consumers who used them for innumerable purposes far removed

[7] For a discussion dealing with the present administrative interpretation of "sub-contracts," in the light of historical antecedents of the statutory definition, see, in this symposium, Kenney, *Coverage and Exemptions, supra* pp. 263 ff.

[8] For the extension of the Renegotiation Act to contract brokers, see, in this symposium, Kenney, *Coverage and Exemptions, supra* p. 263, at 268.

from war production. The determination of the renegotiable business of the screw manufacturer and of all preceding manufacturers in the chain of screw production thus presents a difficult problem.

All sales of such products as specific parts for an airplane, a tank, a jeep, a gun, a gun mount, or any one of hundreds of items which now have only war uses, are war business. Sales to customers known to be engaged solely in war production can quickly be identified. A scrutiny of priority ratings, CMP allotment numbers (which are entered on the certification on a purchase order, in accordance with CMP regulation No. 1 or No. 3), and other designations which some Divisions of the War Production Board require manufacturers to enter on their purchase orders for certain types of materials, will reveal something as to the probable end use of the articles delivered thereunder. It would be unfair to a contractor, however, for a negotiator or analyst to assume that because a company's product was given a high priority rating or CMP allocation, its end use was necessarily such as to make all its business renegotiable. High ratings have been given to materials and products required by hospitals and schools. Containers and materials used in their manufacture receive high ratings when they are to be used in connection with foods, but contracts for such foods purchased by the Department of Agriculture for Lend Lease, and hence their containers, are not subject to renegotiation.

Producers whose sales are made exclusively through regular trade channels may have to resort to percentages to estimate what amount is renegotiable. Thus, if it is reliably determined that 75 per cent of a particular article had a war end use in 1942, an individual producer might be permitted to allocate 75 per cent of his 1942 sales of that article not fully paid for prior to April 28, 1942 as renegotiable, but it must be understood that this is not a common practice. A more nearly accurate estimate of renegotiable business may usually be obtained through circularizing representative customers as a basis for obtaining percentages of renegotiable business which may then be applied to all customers of the same type. Trade association reports have been used to suggest the extent to which specific industries are engaged in war production and thereby indicate the renegotiable proportion of an individual manufacturer's output which they absorb. Such reports need to be used with caution, however, for not only have many trade associations been somewhat optimistic in their estimates of the extent to which their members have contributed to the war effort, but the proportion of war end business of one manufacturer varies greatly from that of another.

A careful analysis of deliveries for one or two months may provide a clue to the proper segregation of a company's business into renegotiable and non-renegotible components. Where the records give no clear indication of the probable end use of a company's output, many analysts have found that the most reliable estimates of the volume of its renegotiable business can be secured from the sales department rather than from the accounting department. Many concerns now ask their salesmen and servicemen who are in direct touch with their customers

and with the industries which use their products, to report regarding the extent to which they go into war production. Frequently a combination of several procedures may be required to obtain a satisfactory segregation of a contractor's renegotiable and non-renegotiable business. The Boards do not recommend procedures that involve an enormous amount of work in order to obtain a meticulously accurate segregation, nor do they approve of the use of pure unsupported guesswork, which is fully as likely to work to the disadvantage of the contractor as to that of the government. The application of a practicable procedure which does not involve an undue amount of the contractor's time and effort is usually acceptable to the Boards and a contractor will make a mistake in undertaking the job before consulting with the renegotiation agency to which his case is assigned. Usually he will find that a practical solution that will not work any hardship on him can be agreed upon. Trade association reports sometimes suggest the extent to which industries may be engaged in war production and thereby indicate the renegotiable proportion of an individual manufacturer's output which is absorbed by such industries. A careful analysis of deliveries for one or two months may provide a clue to the proper segregation of a company's business into renegotiable and non-renegotiable components.

Exemption of War Business Paid for Before April 28, 1942. For some companies segregation involves the elimination of sales of products specifically exempt under the Act. Such exemptions include all sales under contracts, payment for which had been completed by April 28, 1942. Companies whose business is chiefly on the basis of purchase orders, rather than identified with more formal contracts, are likely to find that the total of their outstanding customers' accounts at April 28, 1942 will be subject to the same analysis for renegotiability as their subsequent sales. The entire volume of sales under a contract for a specified number of units, each of which is to be paid for upon delivery, is subsequent to renegotiation unless all payments finally due under the contract were paid for before April 28, 1942. The Boards have agreed, however, that if a contractor completely fulfilled his part of the contract and the balance unpaid at April 28, 1942, was relatively insignificant and was withheld because of disagreement as to the amount, or for some similar reason, they would waive the technicality of the law and look upon it as non-renegotiable. Such a waiver is not based upon the amount alone. All of the circumstances surrounding the delay in payment are scrutinized by a Board to be sure that it can justify its treatment of the contract.

Exemption of Sales of Products of Mines, etc. Of the mandatory statutory exemptions the only other one of direct interest to private contractors relates to contracts and subcontracts "for the product of a mine, oil or gas well, or other mineral or natural deposit, or timber, which has not been processed, refined or treated beyond the first form or state suitable for industrial use."

This provision of the Act was introduced for the purpose of encouraging the production of certain depletable materials the exhaustion of this country's supply

of which was uncomfortably near, but which are the basic sources of critical and strategic materials. To provide this encouragement the exemption was couched in terms that were broad enough to include contracts for a number of the products of mineral and natural deposits for the production of which no such encouragement was necessary.

The Price Adjustment Boards interpret this provision to include only wasting assets or materials normally subject to depletion. Such materials as water, sea water and air, and derivatives therefrom, and gums and vegetable juices derived from living or vegetable products are not deemed to be wasting assets, and contracts and subcontracts for such items are therefore subject to renegotiation. Thus, while contracts for the sale of timber are exempt, those for the sale of turpentine or other resins extracted from the living trees are not exempt from renegotiation.

In determining whether a contract for a particular product, clearly related to the types specified by the Act as exempt, is itself exempt, the Boards apply the principle of the dispersal point, that is, the point at which the product is used in substantial quantities by the ultimate consumer, or by industries other than the industry of origin. The industry of origin may be merely the industry of actual extraction or severance, such as mining or timber falling, or it may include processing, refining or treatment, applied to the extracted or severed product, of a character necessary to make it usable, either to the ultimate consumer or to industris which use it in the manufacture of other products. Thus, coal mining companies are completely exempt from renegotiation, for though they may put the direct product in the mine through a series of manufacturing operations, such as crushing, screening, grading, washing, etc., one or more of them is necessary to make the coal suitable for consumer or industrial use. Aluminum production through the ingot stage has been exempted, although it is recognized that bauxite, the original mineral or natural deposit from which aluminum is ultimately produced, is also used in the manufacture of fire bricks, artificial abrasives and mineral oil refining, as well as in the production of alumina, which, though principally used as the direct source of aluminum ingots, is also used as an abrasive, a fixing agent in dyeing and for other industrial purposes. Since approximately eighty-five per cent of the bauxite extracted in the United States is processed into aluminum ingots, the Boards took the position that as a practical administrative matter little was to be gained by fixing the dispersal point closer to the mining stage. A contract for the analytical processing of a product into one or more of the chemical elements or compounds present in it in the state in which they are normally found, is also exempt. Contracts not only for the mining, therefore, but also for the smelting of ore are exempt from renegotiation.

In general, contracts for products which are the result of a combination of substantial quantities of two or more materials are subject to renegotiation. A problem arises where the same product is obtainable from different procedures, one of which would meet the test of exemption, while the other would not. Salt, for

example, is one of the exempt products when it is produced by the common method of mining or extracting it from deposits, but when it is obtained from sea water by the distillation process, it becomes subject to the interpretation that contracts for products derived from water, sea water and air are not exempt. Similarly, cement is exempt when it is produced from quarried rock with relatively simple processing to prepare it for industrial uses but when it is manufactured by combining several materials, each of which has industrial uses independent of its participation as a component of cement, it is not considered to be within the purview of the Act with respect to exemption.

Every product, a contract for which is exempted from renegotiation under this paragraph of the Act is presumed to have a readily determinable market price. Companies so integrated that they extract the raw material, process it, and from the processed raw material fabricate or further process the items which they sell, are permitted to include, as a cost of the latter, the exempted raw materials used therein at such an amount as, in the opinion of the Price Adjustment Board, fairly represents a properly applicable allowance. In determining this amount due consideration is given to the established sale or market price where there is a representative market for the product in the first form or state suitable for industrial use, and to such other factors as may be necessary to reflect the purpose and intent of the exemption accorded under the Act. In general, it is the purpose and intent of this provision to allow to the contractor engaged in an integrated process of the type described, an item of cost substantially equivalent to that granted by the statute to others who sell an exempted product, namely what it could have realized if it had sold the exempt product at the intermediate stage.

Discretionary Exemptions. With respect to some contracts of the types which the Secretary of a Department may, in his discretion, exempt from renegotiation, the Secretaries of the War Department and the Navy Department have issued regulations, which if not substantially duplicated by other Departments with Price Adjustment Boards, have been concurred in by most of them. These regulations exempt from renegotiation, on the ground that profits thereunder can be determined with reasonable certainty when the contract price is established, contracts and subcontracts (1) for the purchase or lease of any interest in real property, (2) for any of a long list of perishable fresh or frozen uncanned foods, (3) for the furnishing of commodities and services by public utilities and common carriers at published rates fixed, approved or subject to regulation by a public regulatory body, and (4) for commodities, the minimum price for the sale of which has been fixed by a public regulatory body.

Exemption of Contracts Affecting Real Estate. It should be observed that the first provision of this regulation, which deals with transactions in real property, exempts from renegotiation contracts and subcontracts for the purchase or lease of any interest in *existing* real property, but does not relieve from renegotiation contracts to sell, furnish or install machinery, equipment, materials or other personal

property which would otherwise be renegotiable, merely because such property is to be installed in a building or become so affixed to it as to make it thereafter a part of the real estate. Nor does it exempt from renegotiation contracts and subcontracts thereunder for the construction of a building or other improvements to real property, to which the Government will take title. On the other hand, similar contracts for the construction and equipment of buildings to which the Government will not take title, even though such improvements are covered by Certificates of Necessity, are not subject to renegotiation. It is necessary therefore to look beyond the superficial character of a contractor's operations to determine whether or not they should be included in his renegotiable business. Thus, whether A sells a war plant site to the Government or to the B Company, the transaction is excluded from renegotiation. If A then builds thereon a building, and otherwise improves the real estate, equips the building with machinery and other facilities, all for the account of the Government which is to take title to it, he is subject to renegotiation with respect thereto. If he does the same thing for the B Company, which will receive title to the property upon its completion, neither he nor any of his subcontractors is subject to renegotiation with respect to that part of the contract and subcontracts pertinent to the construction or to the furnishing or installation of equipment which is not to be used in processing a renegotiable article but they will be subject to renegotiation on the furnishing and installation of machinery and equipment which is to be so used even though such property is to be affixed to the real estate in such a way as to become real estate for some other purpose.

Exemption of Contracts for Perishable Goods. Perishable fresh or frozen uncanned foods have been exempted from renegotiation by the Secretaries under the authority granted by the Statute. Many such commodities are purchased by supply officers at forts, camps, ports, and bases from nearby sources of supply, and very often do not exceed $100,000 from any one person in a single year. To a large extent the actual costs to the vendor and hence the amount of his profits are difficult to obtain. Many purchases of perishables are made on a day to day or week to week basis, at the best prices available and it is recognized that, in general, competition is likely to play a larger part in the establishment of their prices than is the case with other products. Undoubtedly, the administrative task involved in renegotiation of perishables also encouraged the Secretaries to make this exemption.

Exemption Affecting Companies Subject to Public Regulation. The third and fourth classes of commodities and services, sales of which the Secretaries have used their discretionary power under the Act to exempt from renegotiation, are those provided by common carriers and public utilities. While many compnaies in these fields are either prime or subcontractors, yet with legal rates or minimums established by state and federal commissions it may be assumed that they are subject to adequate controls. Since the Renegotiation Act is a pricing act, any attempt on the part of the Price Adjustment Boards to modify prices (other than applied ceiling prices), fixed or approved by other government bodies, would involve considerable administrative difficulty as well as unnecessary duplication.

Sales to Post Exchanges, etc. Because sales to Army Post Exchanges and to Navy Service Stores have been treated by the Boards as non-renegotiable, it has been thought by some that they were subject to a special exemption. The real reason for their elimination from renegotiable business, however, is the fact that the purchases of these organizations are not made by the War Department nor by the Navy Department. Their working capital is supplied by officers of the Army and Navy, respectively, and the proceeds from their operation do not revert to the Government in any way. Sales of goods to be resold to enlisted personnel and their families through Army commissaries and Navy stores are subject to renegotiation (except with respect to perishables specifically exempt), since such sales are made directly to the War and Navy Departments.

RENEGOTIABILITY OF PATENT LICENSES

Public Law 768, 77th Congress, approved October 31, 1942, authorizes the head of a government Department or agency which has ordered the manufacture of a product which is based on an invention, patented or unpatented, with license from its owner which provides for the payment of royalties believed by him to be excessive, to "fix and specify such rates or amounts of royalties, if any, as he shall determine are fair and just, taking into account the conditions of war time production." This statute further provides: "Nothing herein contained shall be deemed to preclude the applicability of Section 403 of Public Law 428, 77th Congress (the Renegotiation Act) as the same may be heretofore or hereafter amended so far as the same may be applicable."

It has been ruled that patent licenses for processes or inventions required in performing contracts with the Departments and subcontracts thereunder, are subcontracts, and unless specifically exempted, subject to renegotiation. There are numerous instances of individuals and corporations that have granted the use of their inventions and processes, license free, to the Government for purposes of war production. In other cases, because to do so would deprive an organization of its entire wherewithal to carry on further research, or because of existing license contracts which cannot be changed, or because of other conditions, the need for renegotiation is important. In many such cases the war-time income from royalties based on license agreements originally negotiated in anticipation of peacetime production, has been so far in excess of the fondest dreams of the patent holders, that the excessiveness of profits involved therein is easily established. Even rates fixed under Public Law 768 may not prevent excessive profits from patent royalties. In one case a company that complained that rates so fixed were too low, realized from patent royalties during the first six months thereafter several times what it had ever realized in a full fiscal year prior thereto.

COSTS AND EXPENSES APPLICABLE TO RENEGOTIABLE BUSINESS

Since the Renegotiation Act was designed to eliminate excessive profits on renegotiable business only, it is necessary to ascertain the amount of costs and ex-

penses properly applicable to such business as distinct from those chargeable to non-renegotiable sales. While the cost analyst is not expected to make the examination required to accomplish this, he is expected to consult and advise with the contractor relative to the methods used in obtaining the amounts of costs and expenses charged to each category, and to satisfy himself that such methods are sound and are based upon full consideration of the relationship of the expenditures to the types of sales to which they have been applied. If the contractor's cost system is comprehensive and of a type thoroughly suitable to his business, it may be assumed that the costs of specific products will be reasonably accurate. If his wartime products are identical with those of his peacetime operations, costs applicable to renegotiable business will basically bear the same proportion to those applicable to non-renegotiable sales. Where no adequate cost system is in operation a careful analysis of expenditures must be made, either by the contractor or his auditor or by a representative of the Price Adjustment Board, as circumstances dictate.

Relation of Allowable Costs to Income Tax Deductions

The basic allocation of costs and expenses is likely to require adjustment for special items. In general, a "Secretary shall recognize the properly applicable exclusions and deducations of the character which the contractor or subcontractor is allowed under Chapter 1 and Chapter 2E of the Internal Revenue Code" (Sec. 403(c)(3)). Specifically, "the Secretaries of the respective Departments shall not make any allowance for any salaries, bonuses, or other compensation paid by a contractor to its officers or employees in excess of a reasonable amount, nor shall they make allowance for any excessive reserves set up by the contractor or for any cost incurred by the contractor which are excessive or unreasonable" (Sec. 403(d)).

With respect to the first of the two foregoing provisions of the Act, the Boards emphasize the significance of the phrase "applicable exclusions and deductions . . . *of the character* allowed under Chapter 1 and Chapter 2E of the Internal Revenue Code." Although such Code provisions guide the Boards in their allowance of expenditures as charges against renegotiable income, they do not feel bound to use in all cases, the amounts the Bureau of Internal Revenue may accept. In the matter of depreciation, for example, a Board may accept a contractor's computation of accelerated depreciation resulting from war production, even though a portion of it may ultimately be disallowed for tax purposes by the Bureau of Internal Revenue. In the treatment of amortization of facilities acquired under Certificates of Necessity, the Boards treat as an operating expense whatever portion of the charges seems to represent normal depreciation, and deduct the balance from profits to arrive at the amount of profit from which excessive profits are to be eliminated. Both the Bureau of Internal Revenue and the Price Adjustment Boards recognize amortization as a deduction in full, but treat the amount differently. The Board's treatment is for the purpose of obtaining from companies which are

allowed amortization of facilities profit figures that are comparable with those not so favored.

The Boards may allow against renegotiable sales, salaries and other compensation in amounts greater than those which the Bureau of Internal Revenue subsequently approves as a deduction for income tax purposes.

Because they are charged with recognizing the same types of costs and expenses as are permitted for federal tax purposes, consideration must be given to the returns that have been filed by the contractor and to the reports of Internal Revenue Agents based on their examinations of the records upon which such returns were based. If, however, the Boards were to delay their decisions until the Bureau of Internal Revenue could complete its audit of every contractor subject to renegotiation, in order to be sure that they allowed expenses in the same amounts as the Bureau of Internal Revenue, the real purpose of the Renegotiation Act would never be realized. It must be remembered that this Act was designed, not to secure more taxes, but to eliminate excessive profits from war contracts and, as part of the same procedure to aid in securing lower prices on future contracts. For these purposes, and particularly the latter, speed in accomplishing the task is of the highest importance.

Excessive Compensation

The Secretaries, and through them the Boards, are charged specifically with the disallowance of excessive costs resulting from unreasonably high payments of compensation (whether in the form of salaries, bonuses, commissions or a combination of them) to officers and employees, from unreasonable provisions against future contingencies or commitments, and from any other expenditure. Some companies, whose sales as the result of the war have catapulted astronomically, have increased the compensation paid to key men to fantastic amounts that are in no way justified even by the increased responsibility which increased business has placed upon them. In other instances wages of workers have been raised beyond the amounts earned through regularly approved overtime rates, as the results of bonuses and "incentive payments," to figures out of all proportion to any conceivable valuation of their services. Whether or not such payments are excessive under the various circumstances of their payment, it is the job of the Boards to determine. To assist them in arriving at a fair decisions the cost analyst must obtain from the contractors the facts and an explanation of them.

In general, in considering the reasonableness of compensation to officers and higher paid employees, attention is paid to the nature of the work, extent of responsibility, experience and effectiveness of the individual, increases in compensation since January 1, 1941, and amounts paid to persons similarly employed in other companies of the same industry. There is no attempt to be picayunish in this survey; the judgment of the management in fixing its employees' compensation is given great weight. Wage restrictions under Executive Orders and under Reg-

ulations issued by the Director of Economic Stabilization, are recognized as a basis for determining whether or not in given instances payments to employees are excessive. A certificate from the contractor relative to his compliance with such regulations is acceptable to the Boards. In partnerships, where partners are not allowed specific "salaries," amounts considered reasonable in view of the size and character of the business are allowed to all active partners before arriving at the profit the excessiveness of which is to be determined.

Taxes

While federal income and excess profits taxes are not allowed as costs or expenses in the determination of profits, all other federal taxes and excises and all taxes to states and other taxing jurisdictions, paid or accrued in accordance with legal formulas, are allowed as costs either to be apportioned or applied specifically against renegotiable business, as the circumstances justify. Real estate and other property taxes, for example, are usually charged only against the production obtained from the use of the properties subject to such taxes. Social security taxes are related to the labor costs of renegotiable and non-renegotiable production, respectively, on the basis of payments made on account of the actual labor employed in each type. Where the cost procedures so include such items in overhead that actual reapplication is difficult, the cost analyst is expected to be sure that the method of apportioning such overhead between renegotiable and non-renegotiable production does substantial justice to the costs of each kind.

State income taxes and franchise taxes based upon income, are allowed as expenses apportionable to renegotiable business, but since the amount of such taxes may be subject to adjustment as the result of renegotiation, it is generally agreed with a contractor that whatever tax refund he may obtain from a state, when such refund is based on a recalculation of the taxes as the result of renegotiation, will be turned over to the Treasury Department as excessive profits.

Employee Pension Funds

When a contractor has established a pension or retirement fund, to which it makes regular contributions, for the benefit of employees, the portion of the contribution pertinent to employees engaged in war production will be allowed as a cost against renegotiable business, provided the expenditures by the contractor are of a type generally approved by the Bureau of Internal Revenue as proper deductions for tax purposes. When such funds have been established for many years no question of their legitimacy as costs is likely to arise. If a plan provides for annuity or pension credits for services rendered in prior years, the amount allowable as an item of cost against renegotiable business will not be permitted to exceed the amount contributed on account of current services plus 10% of the total amount required to provide in full for such past service credits.

Provisions for Contingencies

Similar examinations are made with respect to credits to reserves of various kinds. It may be entirely proper for a contractor to provide for possible expenditures to meet guarantees with respect to his product. Whether the amount of his provision is excessive must be determined in the light of his past experience under such or similar guarantees, the terms of the contracts which contain them, the costs involved, etc. Provisions for accelerated depreciation are allowable costs but only to the extent that the conditions under which the company is operating justifies them. These are matters of both fact and opinion, but a Board's judgment with reference to the propriety of the amount allowable, for example, for accelerated depreciation can be sound only to the degree that adequate factual data are available. So the cost analysts must develop them—the types of equipment affected, their probable useful life, the conditions of operation, effect of abnormal hours of plant operation, abuse by unskilled operators, adequacy of maintenance, etc.

Provisions for postwar conversion, and other provisions for contingencies cannot be allowed as costs chargeable against war business. They are not of the character allowed under Chapter 1 and Chapter 2E of the Internal Revenue Code, nor are they proper deductions under any acceptable method of determining profits. The expenditures for which such reserves are set up may ultimately be proper deductions for tax purposes when they are made, but the impossibility in most instances of determining either the propriety of their amount, in relation to the ultimate use of the funds to which they relate, or their relation to current war production, denies them the right to recognition as a legitimate and allowable cost applicable to present war business.

Treatment of Non-Manufacturing Expenses

The propriety of an allocation of the costs of sales, and resultant gross operating profit, is usually determined in connection with an examination of the cost methods used. While individual items of cost, even when the basis of allocation is sound, are not to be neglected, because excessive costs are often found among them, each item of non-manufacturing costs and expenses is subject to scrutiny for excessive items, the most common of which are abnormally high salaries and bonuses. While interest expense may frequently be apportioned to renegotiable and non-renegotiable business on the basis of sales, this is not necessarily equitable. Interest on a mortgage on property used exclusively for non-war production should not, except under most unusual circumstances, be charged against war production. On the other hand, interest on a V-loan may, under most conditions, be treated in full as an expense applicable to renegotiable business. In every case the facts must be determined and the decision based on the circumstances.

Occasionally a company may have buildings and equipment for which it has no immediate use, for either war or non-war purposes. Unless they are idle purely

because of conversion to war, the expense of guarding, protecting and maintaining such facilities is not a proper charge against renegotiable income.

Selling expenses, including advertising, require particular inquiry. The accounts of many companies still show substantial amounts for sales salaries, salesmen's expenses, commission, etc., even though the persons to whom the amounts charged under such categories are paid, no longer do sales work but act as service engineers, expediters, inspectors, etc. To the extent that their services are related to war business, reasonable compensation paid to such persons is applicable thereto. Long standing arrangments whereby salesmen, agents, dealers and distributors receive commissions based on deliveries of certain products within specified territories, cannot be set aside over night, unless a manufacturer is willing to abandon any hope of retaining or recapturing his regular markets after the war. The existence of unexpired agency contracts in many cases adds to his difficulty of eliminating or reducing selling expenses during the war. In the case of many subcontractors commissions paid in accordance with a long established practice are completely justifiable, not only from the viewpoint of the contractors, but from that of the Government as well, for the recipients have rendered valuable service in spreading the job of war production among a larger number of manufacturers than would otherwise have been possible, and have followed up the contracts after they have been obtained. In other cases individuals have been the beneficiaries of commission arrangements to an extent so great as to leave no doubt that the compensation paid was far greater than the service rendered could possibly have been worth.

Commissions or compensation contingent upon obtaining contracts directly from the Government are frowned upon by the Boards, on the theory that during war time any manufacturer who is able to produce something that the Government needs in carrying on the war, needs no agent to get a contract. While the theory is sound, it has fallen down many times in practice, for many contractors have spent days and weeks in Washington unsuccessfully trying to get contracts, only to be swamped with them shortly after turning the job over to a broker. Payments under brokerage contracts entered into prior to the beginning of the first year covered by renegotiation are generally allowed as a charge against renegotiable sales. As mentioned in an earlier paragraph, however, the broker will be subject to renegotiation.

On the other hand, the expense of maintaining a Washington office, or even a Washington representative, provided he is not rewarded on a contingent basis for his services in securing prime contracts, is recognized as a legitimate deduction. Again, while each case must be considered on its merits, the expenditures need to be scrutinized carefully, and any portion of them deemed to be illegitimate charges against war business must be transferred to the non-war section of the statement.

Advertising expenses, to be allowable deductions in computing the profit on war business, must be reasonable both in amount and in their relation to the advertiser's business activities. Consideration is given to both institutional and product

advertising. In general, straight product advertising, designed to publicize the merits of a contractor's specific products, is chargeable only against his non-renegotiable business, unless it relates to products which he as a subcontractor is providing for war purposes. The cost of institutional advertising may be partially or wholly allowed as a cost against war business, depending upon the relative change in the character of the contractor's business as the result of his conversion to war production. It is not expected that the total amount of a contractor's budget for such advertising during the war period will exceed that of his prewar days. If, in spite of his conversion to war production there has been no diminution of his non-renegotiable business, the entire amount of his expenditure for institutional advertising will be charged against such sales. If, on the other hand, his conversion to war production has left him with no non-renegotiable business, its reasonable cost will be allowed as a deduction in computing his profit on war business. If, as the result of conversion, his non-renegotiable business has suffered, he will be permitted to transfer a portion of the cost of his institutional advertising to renegotiable sales not less than the corresponding ratio during the prewar period. If the total amount of institutional advertising cost is substantially in excess of the corresponding prewar expenditures, some of the excess is likely to be disallowed as an expense against renegotiable business.

The treatment of taxes and pensions funds, both of which may involve expenditures of a non-manufacturing character, have been discussed in an earlier paragraph.

No major expenditure of a contractor is overlooked in an effort to allocate properly to renegotiable and non-renegotiable business, respectively, his costs and expenses. The cost analyst reviews the segregations prepared by the contractor, and in his report to the negotiator or general analyst recommends such changes as seem to him to be in order.

Effect of Disallowances

The fact that items of cost which a Board believes to be excessive are disallowed with reference to renegotiable business merely means that the portion of such costs or expenses, which under acceptable allocations would be charged against renegotiable sales are, upon disallowance, applied to non-renegotiable business. This has the effect of increasing the amount of profit on renegotiable business with an offsetting decrease in that on non-renegotiable business.

FACTUAL REPORTS AND DISCUSSIONS WITH CONTRACTOR

Based on (1) the information supplied by the contractor, (a) in response to the Assignment Office's request for data, (b) in response to the request for financial data and other information on the part of the Price Adjustment Board or Section to which the contractor was assigned for renegotiation, (c) in conversations with him and his employees, and (2) facts and opinions obtained from such other sources as the procurement officers, who are familiar with his operations, the Bu-

reau of Internal Revenue, etc., the analyst or negotiator prepares a report which succinctly embodies all the essential facts upon the basis of which the members of the Board or renegotiating group can familiarize themselves with the case before engaging in final discussions with the contractor. In addition to a summary of the significant financial data, including an income statement for the year under renegotiation, analyzed with respect to renegotiable and non-renegotiable business, income statements for the prewar period, and a balance sheet at the end of the renegotiable year, this report contains evidence of the character of the contractor's contribution to the war program, the difficulties under which he has had to operate, the special advantages he has had, etc., together with suggestions of matters to be developed more fully with the contractor during the renegotiation discussions.

The renegotiation proceedings with respect to a contractor reach a climax in the discussion which the renegotiating group holds with the contractor after they have thoroughly analyzed and digested the factual reports relative to his case. The members of this group reach no conclusions regarding the amount of excessive profits the contractor has accumulated, until they have heard the contractor explain what he has done to earn the profits reported. A discussion of his revelations, coordinated with the factual data obtained by the cost analyst and the negotiator or general analyst, results in a proposal to the contractor that he refund a stated amount of excessive profits, or an acknowledgment that his operations for the period under review have yielded no excessive profits.

Contractors sometimes contend that a Price Adjustment Board determines what amount of profit it will allow a manufacturer, and will not thereafter budge from that conclusion, with the result that the contractor is compelled to accept the Board's judgment as final, or submit to a unilateral determination by the "Secretary" of the Department or Agency responsible for the renegotiation. There is some justification for the feeling of many contractors that a Board's proposal relative to the amount of profit it will agree to as excessive in a particular case is final. But this does not mean that there is anything arbitrary about the manner of its determination, nor that the process by which the amount of a proposed refund or adjustment is fixed is not negotiation. From the commencement of the renegotiation with respect to a contractor, his representatives work with representatives of the government, not only in the accumulation and analysis of financial data, but in discussion of their significance and of the intangible factors involved in the contractor's operations and accomplishments, all with a view to a mutual understanding of the problems involved and, based thereon, a determination of a fair compensation for the job done. When all of the factors disclosed have been carefully weighed and considered by a Board's members in the light of their information regarding comparable operations of and settlements with other contractors and in view of their own independence of personal financial bias in the case it is natural that the Board should feel that it can and does make its first proposal a fair and reasonable one which it should not change unless new evidence can be presented

to justify another conclusion. If the contractor really believes that the Board's proposal is not fair and reasonable, he can refuse to accept and let the matter be referred to the Under-Secretary (or his counterpart if the renegotiating Board is in neither the War nor Navy Departments) for a unilateral determination from which he may appeal to the courts.

STANDARDS OF RENEGOTIATION

It cannot be denied, however, that the Price Adjustment Boards have an advantage in their dealings with contractors, in consequence of which they have felt keenly their responsibility to develop standards and procedures, involving a thorough study, by a group of qualified men, of all the factors pertinent to the problem, which would result in proposals of settlements that would be recognized by all concerned as fair and reasonable.

The application of standards to the problems of renegotiation should not be confused with the use of a rigid formula whereby a profit to be allowed a contractor may be computed. The Boards have considered many suggested formulae designed to determine the amount of a contractor's excessive profits from war production, but have found none that is universally applicable. Each company is an individual problem; no two are alike. A fair rate of profit, based on the sales of a paper manufacturer, would be entirely inadequate for a manufacturer of tanks or complicated precision instruments. Even within the same industry a company with a new modern plant, fitted out with new machinery, arranged with a view to the most economcial production, and all provided by the government, is not entitled to the same rate of profit as one that produces the same articles in an old plant, perhaps not designed in accordance with the latest ideas for the most efficient production, but all provided by the contractor without government aid. The concern that makes its patents available license-free to other war contractors is entitled to a different consideration than the one that does not. The company that lends its personnel to teach other manufacturers production methods, even at the risk of thereby creating post-war competitors, is deserving of recognition which should not be accorded to the concern that does not do so. The contractor who constantly improves manufacturing processes and procedures which reduce unit costs, and passes the benefits on to the government in price reductions, is more worthy of a generous rate of profit than the one who does little to reduce costs or who does not reduce prices as his costs go down but, instead, maintains a margin of profit so wide that it virtually eliminates risk. The varieties and degrees of difference between the operations of contractors are such that no formula for the determination of excessive profits is likely to be devised which will replace the combined judgment of a group of men, qualified by years of business and professional training and experience, to evaluate the performance of a contractor as a basis for determining the amount of excessive profits he has accumulated.

A standard is a basis of comparison. A performance standard may be either an

ideal of attainment or a normal accomplishment. It is in this latter sense that the Price Adjustment Boards use the term in scrutinizing a contractor's profits and accomplishments.

One of the standards which the Boards use in determining excessive profits is the prewar experience of the contractor. For this purpose the four-year period ended with the close of the contractor's 1939 fiscal year is generally taken as a basic period, the average results of which are likely to be approximately normal. If a contractor is not to be permitted to make excessive profits from war business, it is natural and proper to learn what he was accustomed to earn under peacetime conditions, when volumes, prices, expenses and profits were governed largely by competitive conditions, which tended to weed out the inefficient and high-cost producers and to strengthen the efficient low-cost manufacturer.

The 1936-1939 period was selected because it was felt to be long enough to provide a reliable picture of a concern's habitual operative progress, recent enough to reflect the operating ability and experience of its present management, sufficiently pre-war to be relatively unaffected by the war, but short enough to permit of the easy accumulation of the pertinent data. Furthermore, it was felt that it was generally a fairly representative period, since it includes two moderately good years (1936 and 1939), one very good year (1937) and the "recession year" (1938). Moreover, it was the period legally recognized as a basis for computing the excess profits credit, under the Second Revenue Act of 1940 and its successors.

Although a contractor's profits during a renegotiable period are compared with those he earned during this pre-war period, it should not be assumed that the war profit he may retain (before federal income and excess profits taxes) is limited either in amount or as a ratio to sales, net worth, or any other figure, to his average, maximum or minimum pre-war profit. When the pre-war activities of a company or the results of its operations were such that to use them as a basis for comparison with profits on war business would be eminently unfair, they have been completely disregarded or certain years eliminated. In some instances a company's business is more cyclical in character than that of most companies, with the result that a period of four years is inadequate to suggest accurately its profit history or expectations. In such cases, too, the selected period of four years is rejected as a basis for obtaining normal profits, and if possible, a longer period, including the years 1936-1939, will be considered for that purpose. Other companies are engaged in types of war production so different from their normal peacetime operations, either wholly or partially, that a comparison of profits from one with those from the other would be unjustifiable. In any given instance, then, a concern's pre-war record provides a standard by which the excessiveness of its war profits may in some measure, be gauged, only to the extent that such record is indicative of normal operating results during the pre-war period. Under any circumstances it must be recognized that this is only one of many factors to be considered in a particular case.

Another standard used by the Boards is the pre-war experience of an industry.

In many instances an indication of a reasonable profit on war business can be gained by comparing the results of an individual company during the renegotiable period with those of the industry as a whole, or of a group of representative companies in the industry, during the pre-war period. This is particularly useful when the contractor has no pre-war record, or an abnormal one, or has undergone a reorganization or a change in management. It is also helpful in determining how close to normal the pre-war experience of an individual contractor may be.

In the manufacture of many war articles there is no adequate pre-war experience to provide a comparative basis for measuring excessiveness of war profits. In such cases pre-war results, whether on a company or on an industry basis provide only general information regarding the types of profits companies engaged in the employment of similar skills have been accustomed to make and as to the relative standing of a company in competitive operations. The factors which a Board considers in determining whether or not a contractor's operations during the years 1936 to 1939 inclusive were abnormal, are similar to those of which the Bureau of Internal Revenue takes cognizance in connection with a taxpayer's application for excess profits tax relief pursuant to the provisions of Section 722 of the Internal Revenue Code. Accordingly, a contractor who has taken steps to secure such tax relief may find it desirable to submit a copy of his Section 722 application to his renegotiation Board rather than to prepare a statement especially for it, as evidence of his belief that his operations during the years 1936 to 1939 were not normal.

Profits for a period are commonly measured in relation to sales, to costs, to net worth (either at the beginning of the period or the average for the period), or to total assets (either at the beginning of the period or the average for the period). Without neglecting the other ratios, the Price Adjustment Boards have, in general, used sales as a basis for the measurement of profits on war business. Probably the major reason for this is the fact that business men commonly express profits as a ratio of sales whenever they are discussing pricing policies but it is also partly due to the fact that when companies are engaged in both war and civilian production it is frequently difficult to divide profits in terms of their relation to the invested capital or total assets employed in each phase of the business. The inequities involved in relating profits to assets and net worth because of the difficulty of making comparable evaluations of the bases among different companies has also been of some significance in this connection.

War production has yielded ample evidence of what business men have long known, that increased production provides opportunities for increasing profits at a rate more rapid than that of the increase in volume of sales. Increases in profits may result from increases in prices, increases of volume or decreases in unit costs, and when all three factors work together may reach unbelievable heights. The demands of the war have supplied many producers with volumes impossible under normal conditions. To counteract this factor alone lower unit prices would prob-

ably be justified, even assuming unit costs remained unchanged. But with increased volume reductions in unit costs were almost inevitable. Fixed overhead spread over a larger number of units of production yields a smaller amount to be applied to each unit. Streamlining production, made possible by orders for very large quantities of the same item, yields direct operating economies. The elimination or reduction of selling and advertising expenses further reduces the unit cost of every item of war production. Such reductions in unit costs facilitate the turnover of capital. On the other hand, economies made possible from increased volume have been to some extent offset by increased wage rates, the use of untrained employees, the cost of training workers, high labor turnover, greater inspection costs, increased cost of plant protection, greater wear and tear on machinery and equipment, etc.

To determine, therefore, on the basis of a mathematical formula, how much of a contractor's profits on war business is the result of his normal business ability, how much is due to the inrease in volume for which the war alone is responsible, how much is the net result of direct economies and savings from the wider spread of fixed overhead, how much is to be credited to extra efforts inspired by his patriotic desire to go the limit for his country, is well nigh impossible.

Another standard of comparison—one very difficult to fix, because it is based on personal judgment gained from wide experience—must therefore be used by the Price Adjustment Boards in appraising the excessiveness of a contractor's profits. This standard is the accomplishment of industry as a whole under conditions of wartime production. How does the A company's job compare, not only with that of the B company, which is engaged in similar business, but with what it should be capable of doing, in the light of what industry as whole has done?

AN ILLUSTRATIVE APPLICATION OF STANDARDS

An illustration may indicate the manner in which the Boards attempt to apply these standards.

Company P has had a very successful career for more than a quarter of a century as a manufacturer of a small variety of electrical specialties, in the field of which, in spite of numerous competitors, it has long been dominant, due to its extremely efficient management, its pioneering in the development of uses for its products, its training of personnel in their operation, and its influence in persuading the industry to standardize on a few styles and sizes. Except in the development of methods and equipment for the manufacture of its output it has made no outstanding contribution with respect to the products themselves. All are standard in the industry and are related to no important existing patents. Since the demands of war had no effect on the character of its product, it had no conversion problem other than a slight expansion in the form of additional equipment (which was acquired without Certificates of Necessity) and will have no reconversion problem, as such, although for some of its products there will be for several years a heavy reduction in postwar demand.

The P Company's sales during the pre-war years 1936 to 1939 inclusive averaged less than $10,000,000 a year, with the total for the low volume year about two-thirds of that of the high volume year. In 1940 the company began to feel the effect of preparations for national defense, for in that year its sales were 20 per cent greater than those of its best preceding year and nearly 50 per cent greater than its average for the period from 1936 to 1939, inclusive. Its sales for 1941 were nearly double those for 1940, and in 1942 mounted further to a total, before renegotiation, of nearly four times its average 1936-1939 record. Profits before taxes hovered fairly consistently around 25 per cent of sales during the six years prior to the war. Based on net worth at the beginning of the year these profits ranged from a low of slightly less than 25% to a high of more than 50%, with an average of nearly 40%.

During 1942 the company's non-renegotiable business, about equally divided between commercial sales and war business, payment for which was received before April 28, 1942, was computed to be about 35 per cent of its total business (before renegotiation), about 90 per cent of its total sales in 1940 and more than 30 per cent greater than its average annual volume during the 1936 to 1939 period. After adjustment of costs and expenses, to apply against non-renegotiable business items not related to renegotiable business, the ratio of its profit before taxes on its renegotiable business was approximately 27.5 per cent, about one-half of one per cent greater than the corresponding ratio on its non-renegotiable business. On both classes of business, therefore, its rate of profit on sales was greater than the average for the six years prior to the war, and its volumes for each class was also greater, which clearly indicated that all of the renegotiable business was over and above what the company might reasonably have expected, except for the war.

In considering what would represent a fair profit to this contractor on his renegotiable business the renegotiating group recognized that the company was the lowest cost producer in its field; that it had for years consistently operated to reduce prices, though not specifically as the result of war production; that it has been largely responsible throughout its history for the development of new uses for its products, with the result that they are essential and critical tools of war production, the use of which has reduced the cost by untold millions of dollars; that it has been instrumental in speeding up the production of its own plant and of its competitors, through cooperation with the latter in improving their manufacturing methods and procedures, with the result that the government has been saved many millions of dollars in plant costs and an undeterminable number of hours of delay in the completion of war products; that its products have always been satisfactory; that its deliveries have always been according to schedule; that it required no financing by the government; and that altogether it has made an important contribution to the war effort. On the other hand, the renegotiating group also recognized that the company had no problem of plant conversion to engage in war business, its war products being identical with those of its peacetime operations; that its genius is reflected primarily in production rather than invention of epochal devices; that

it will have no problem of postwar reconversion; that its postwar reduction in business will not be comparable with that to be suffered by many industries; that its investment in new facilities for war production is relatively small and of standard character; that it has retained its peacetime contacts by preferring subcontracts to prime contracts; that it was not wholly cooperative with government procurement agencies in connection wtih such few prime contracts as it accepted; and that its profit before taxes on non-renegotiable business was greater than its total corresponding profit for any year prior to 1941.

This net result on renegotiable business, combined with its return on non- had done a job which entitled it to a profit on renegotiable business which represented a reward for its outstanding contribution and performance in connection with the war effort, but which must also be related to the degree of its sacrifice in comparison with other types of industry and to the development of inventions of immeasurable significance. As a result of this conclusion its was recommended that the company refund an amount which would leave it a profit on renegotiable business alone, before federal income and excess profits taxes, as follows:

(1) in amount, more than its average annual profit before taxes during the 1936 to 1939 period.
(2) as a rate on adjusted sales (renegotiable sales, reduced by the amount of the refund), more than half the highest rate on its sales for any year since 1935.
(3) as a rate on adjusted sales approximately one-third greater than that allowed any renegotiated company in a comparable business.

The net result of these considerations was the conclusion that the P Company renegotiable business which was entirely unaffected by renegotiation, leaves the company with a return before taxes of approximately twice as much as it made in its best year prior to 1940 and a net return after taxes and all other charges of about 20 per cent on its net worth. While the resultant return after taxes is less in amount than the company enjoyed during a few of its prewar years and less in rate than it was during any of those years, it must be recognized that the tax rate for 1942 is much higher than it was during the earlier period so that all taxpayers must pay substantially larger proportions of their incomes to the government in taxes.

CONSIDERATION OF EFFICIENCY

Contractors are particularly concerned about the Boards' recognition of their efficiency in war production. Many feel that through renegotiation they are penalized for increasing efficiency and lowering unit costs, and that those companies with high costs and relatively low profits fare better than those that strain every nerve to improve production, lower unit costs and pass on to the government the benefits resulting from their efforts. In some instances, highly efficient low cost producers may have suffered, through renegotiation, in comparison with others engaged in similar types of production. If this be so, it is contrary both to the desires and the general practices of the Boards, for particular consideration is given

in every case to evidence of efficient and cost reducing operations, in order to compensate the efficient manufacturer more generously than the less efficient. It does not follow that the efficient producer, merely because of his efficiency, may not have accumulated excessive profits. The opportunity for the demonstration of his efficiency may have been provided by the war. Under conditions of his normal production the opportunities for such notable cost reductions may not have existed.

An example of one who received full recognition of his efficiency is a small manufacturer, whose war product is identical with his peacetime product, and whose 1942 volume, more than half of which was on war contracts, was not substantially greater than his peacetime volume. The profits on his total business in 1942 were at a rate of 60 per cent greater than he had earned during the prewar period. This increase in profit ratio was due, almost entirely, to the installation in 1942 of equipment he had wanted to buy for several years, but which he was unable to do without (as he felt) over-extending himself, financially. In this case the war program received the benefit of improved manufacturing methods, which the manufacturer, because of conservative business habits, had denied himself for several years. With such equipment for his prewar operations his unit costs would have been lower and his consequent profit ratios higher during the years of his base period. In renegotiation he received the benefit of the increased efficiency of his 1942 operation, in comparison with that of the prewar period, by the allowance as normal of the profit he would have made during the earlier years had he had the reduced unit costs which the improved equipment permitted him to develop.

Admittedly one of a Board's most difficult tasks is to determine the relative production efficiency of the various contractors with whom it deals, and the extent to which a manufacturer's success in reducing costs is the result of his own ingenuity as opposed to the application of factors not subject to his control. Through analyses of capital turnover, labor hours per unit of output, nature and extent of government assistance, and a variety of other factors, with special emphasis on economy in the use of facilities, manpower and raw materials, the Boards attempt to obtain the facts upon the basis of which they can justly reward the supercompetent for outstanding efficiency in production and treat with comparable justice all other producers, on the basis of their respective records.

THE SIGNIFICANCE OF SUBCONTRACTING

Another factor to which the Boards attach considerable weight is the degree to which a contractor's operations are integrated. A manufacturer who depends only on the facilities and labor in his own plant to convert raw material into finished war products is generally entitled to a higher rate of profit on sales than one whose operations consist primarily of assembling parts accumulated from a number of other manufacturers because he has more capital invested and adds more value in the process of manufacture. The price of every item furnished by a subcontractor includes a profit which becomes a part of the cost of the final product. Unless the

subcontractor can supply his parts for less than the contractor can produce them in his own plant, the ultimate costs of the latter's product will be greater than it otherwise would be. On the other hand, since from a national viewpoint every plant and facility in the country has been needed, either for direct war or essential civilian production, it must be recognized that without the extensive subcontracting that has been such a vital factor in our development of war matériel, this country could never have become the arsenal of democracy that it is. The cost of some products may have been greater, but the speed with which they were obtained justified the increased cost. Accordingly, under some circumstances subcontracting is a definitely favorable factor for which the contractor is entitled to special rewards. For example, one company, through the utilization of a large number of small subcontractors on more than 95 per cent of its production, turned out over $25,000,000 of critical ordnance items before any plant was equipped to produce them on anything like an integrated basis. The importance, significance and necessity of such subcontracting is not overlooked.

When a contractor sells a product on a fixed price basis, and it develops that he buys all the parts, so that his contribution is primarily that of assembling them, in determining whether he has made excessive profits consideration must be given to the relative value of his participation in the final product. If the purchased parts are standard and easily obtainable, he may not be entitled to a very substantial compensation for his assembly job but, even though the purchased parts are all standard and easily obtainable, if the assembly job is intricate and requires a high degree of technical skill, the reward for his services should be correspondingly greater. Furthermore, subcontractors do not always supply standard parts; they are not always in sound financial condition; they may not use reliable accounting procedures. In such cases, even though the contractor's contribution to the final product may appear to be only an assembly job, actually it may include furnishing his subcontractors with engineering aid, production specifications, financial help, inspection service, accounting and auditing and a variety of other benefits essential to total production. In other words, the contractor's contribution may be one of management fully as much as one of assembling the parts manufactured by subcontractors and he would, accordingly, be entitled to greater profits.

A contractor cannot be accorded fair treatment in evaluating the excessiveness of his profits unless full consideration is given to the nature and amount of subcontracting involved in his production and the character of his relationship to his subcontractors.

CONTRACTOR'S RISKS

Closely related to the matter of subcontracting, though by no means solely involved in it, is the problem of a contractor's risks. Profit is generally considered to be compensation for the use of capital, and the greater the risk involved the higher is the rate of return which owners of capital demand for its use. In war time it is

necessary to allow profits as compensation for a fine production job even though there may have been no capital at risk but, in considering what are reasonable and what are excessive profits, the Price Adjustment Boards must be concerned, to a considerable extent, with the evaluation of a contractor's risks in connection with his war production.

In the early days of preparation for war some of the risks which now seem unimportant were very real. Increases in material costs and increases in labor rates, for example, while possibilities not now completely non-existent, were then of vital concern to every manufacturer. The danger of production stoppages as the results of delays in the delivery of materials and parts is an ever present risk, but more serious for some companies than for others. Many contractors have observed their costs rising because of the inexperience of a large part of their employees, a condition which has necessitated specific job training, and has resulted in slower production, more spoilage and a larger number of rejects than would normally be expected. The difficulties involved in stabilizing labor conditions has caused a high labor turnover in many industries. The employment of women in industries unaccustomed to them, while providing a solution for some problems, has created others.

Some manufacturers are subject to uninsurable risks because of the nature of their production; some are required to provide product guarantees, the cost of meeting which, under present conditions, is largely a matter of speculation. One company at its own expense has sent repairmen by plane to drop on ships in mid-ocean to make the equipment which it installed function properly.

Of particular concern to many contractors is the risk of cancellation of their orders, or of a modification of their production programs which reduces the utilization of their facilities. Contractors whose product is largely produced by subcontractors and whose facilities are in great measure government-owned or acquired under certificate of necessity, ordinarily have less at stake, relatively, than highly integrated manufacturers and those that have received no financial assistance of any kind from the government.

While provisions for post-war rehabilitation cannot be allowed as costs in the determination of profits from renegotiable business, recognition of post-war risks cannot be denied. A contractor whose post-war business is going to be extremely lean because he has flooded industrial plants with equipment needed for war production but which will need no replacement for many years and is adequate for peace-time operations, is deserving of much consideration by reason of that fact in arriving at a fair rate of profit on his war sales. A manufacturer who was dominant in his field before the war and who has sacrificed his regular business in order to do a war job for which his plant and organization were peculiarly fitted, and has assisted in the development of other contractors in the same field, has taken a serious risk with respect to his post-war future, for he has lost a large part of his prewar market for what was formerly his principal product and has created (or

assisted the government to create) a great many competitors in the field in which at one time he had his own way.

Contractors are well aware of the risks they have taken; many, of course, are inclined to exaggerate or over-emphasize them. The Price Adjustment Boards encourage the contractors to present their views clearly on this as on other factors and they take full cognizance of them and evaluate them in profit terms as accurately as possible.

COST-PLUS-FIXED-FEE CONTRACTS

Because most of the risks incident to the performance of fixed-price contracts are not applicable, at least in the same measure, to cost-plus-fixed-fee contracts, the latter are not included in the usual overall renegotiation of a company's fixed price business, but are given separate consideration. Furthermore, when such contracts relate to large physical units, such as ships or construction projects, to consider them on a fiscal year basis is likely to yield inequitable results, since the real profit from such jobs cannot be determined until the contracts are completed. For this reason ship and construction contracts are often renegotiated on a completed contract basis depending upon conditions in the individual case.

In general, the same types of factors are weighed as in the renegotiation of fixed-price contracts. Greater attention is paid, however, to the comparability of a contractor's performance to that of others currently or recently engaged in similar operations than to his prewar experience. Changes in factors governing production subsequent to the signing of the contract may justify a modification of the fee. Thus, in one instance a contract for a small number of units of a particular product specified a fixed fee per unit based on production conditions suitable for the originally contemplated quantity. The subsequent need for a great many units, which were ordered on the same basis as the first quantity, enabled the contractor to change his production methods so radically that the fee per unit yielded a profit, which as a percentage of actual cost was at several times the rate applied to the estimated cost contemplated in fixing the fee originally.

Disallowances of costs must be treated as deductions from the fee in renegotiation proceedings. There are times when, depending upon the nature of the disallowances, a loss or an inadequate profit on cost-plus-a-fixed-fee business will be taken into consideration in fixing the amount of profit to be allowed on fixed price business so as to allow a larger amount than would otherwise have been considered proper.

Fixed fees directly related to production in government-owned plants are fundamentally compensation for management, and may easily become very exorbitant as production mounts beyond the limits anticipated when the contracts were negotiated.

EVALUATION OF CONTRACTOR'S PERFORMANCE

From the foregoing it is evident that in renegotiating the war business of a contractor on an overall basis a Board relates its performance to its prewar experi-

ence, to the general prewar experience of the industry with which it is identified, the experience of other contractors now engaged in similar kinds of production and the significance of the contractor's production to the war program as a whole. By balancing the favorable factors against the unfavorable factors, with due consideration for the risks involved, it tries to arrive at a fair evaluation of the amount of profit to which the contractor is entitled for the job done. In reporting to him the amount of refund the renegotiating group feels it is proper he shall return, its chairman generally enumerates the factors to which special consideration has been given. The complaint is frequently made that the renegotiating Boards do not indicate how much weight they give to each of such factors, and make it impossible for a contractor either to verify the amount of the proposed refund, assuming he accepts the basis of its determination, or to oppose intelligently the determination of the Board with reference to the amount of weight allowed certain factors. To the contractor, the refund recommendation appears to be the result of an arbitrary determination. It cannot be denied that the Boards do not attach specific numerical weights to specific factors which influence their judgment in the final determination. Nor, if they did, is it likely there would be agreement among the several members as to what weight should be applied to each of the factors. In one proceedings the five Board members took a secret ballot and were unanimous in their recommendation of an amount to be refunded by the contractor. Discussion subsequent to the announcement of the results of the ballot revealed that each voter had reached his conclusion in pursuit of a train of thought quite different from that of the others. In other words, each member of the renegotiating group weighted differently the various factors considered, yet arrived at the same net result as all the others. Business men are daily confronted with analogous situations, wherein they are required to evaluate pieces of property or jobs done. They reach conclusions which they themselves would have difficulty in analyzing mathematically, but the soundness of which is admitted by their associates. In buying a factory site, for example, such factors as nearness to raw materials, nature of transportation facilities, with respect to suitability for incoming freight and shipments to customers, availability and character of labor supply, types and amount of taxes, attitude of the community toward industrial plants—these and many other factors must be considered in determining a fair price to be paid. But it is doubtful if any business man attempts to place a value on each factor in arriving at the amount he is willing to offer for such property. His experienced judgment enables him to reach a conclusion which balances one factor against another without identifying the exact degree of importance he attaches to each.

PROFITS AFTER RENEGOTIATION

Whatever the final conclusion with respect to an amount of refund, the resultant profit can be expressed as a percentage of sales. Since the Renegotiation Act has been designated as a pricing act, any refund made by a contractor is in effect a

rebate of price, made because, in the light of the facts developed through renegotiation, not known when the contracts involved were originally placed, the prices named in such contracts were too high. Had they been lower, sales as well as profits would have been less. The refund resulting from renegotiation operates to reduce the sales of renegotiable business as reported before renegotiation, and the profits based thereon. The ratio of profits after renegotiation, insofar as they are related to sales, must therefore be computed with reference to sales after renegotiation.

If, for example, a company's renegotiable business was reported as $10,000,000 on which the profit before federal income and excess taxes[9] was $2,500,000—or 25 per cent of such sales, and as the result of renegotiation it refunded $1,500,000 (also before taxes), its sales after renegotiation would be $8,500,000 and the final profit after renegotiation and before taxes, would be $1,000,000 or 11.76 per cent of "adjusted sales," that is, original renegotiable sales, reduced by the amount of the refund.

EXECUTION OF RENEGOTIATION AGREEMENT

Most contractors are interested in knowing what will happen if they refuse to accept the refund proposal of a Board. Since renegotiation presumes a mutual understanding, discussions usually terminate in execution of a bilateral agreement relative to the total amount of refund and the manner in which it shall be applied to specific prime contracts, with further reference to price reductions applicable to future billings under such contracts and prices to be changed under subcontracts. If the representatives of the contractor are not empowered to enter into such an agreement at the time of their meeting with a renegotiating group, the agreement is not completed until their principals have had an opportunity to pass upon the proposal and have signified their willingness to accept it. It is, however, their privilege to reject it. If the renegotiation group is a Price Adjustment Section in one of the War Department Services or a regional board of the Navy Department, appeal may be made to the top Board of the Department involved, for a reconsideration of the case. If there is still no meeting of the minds, the case is referred to the Under-Secretary for a unilateral determination of the amount of excessive profits involved. The amount of excessive profits found by a unilateral determination may be collected by withholding amounts due the contractor or, in the case of a subcontractor, by ordering prime contractors who are his customers to withhold payments for the account of the government. The contractor then has the right of suit for recovery in the Federal Courts. If there are no funds that can be withheld or collected through the contractor's customers the government has recourse to the courts for collection.

[9] For a discussion of the relation of renegotiation to federal income taxes, see, in this symposium, Watts, *Renegotiation and Federal Taxation, infra* p. 341; also, on the controversy before-taxes vs. after-taxes, see the last article in this symposium by Jules Abels on The 1943 Revenue Bill's Renegotiation Proposals.

PUBLICATION OF RESULTS OF RENEGOTIATION

Nearly every contractor who appears before a Price Adjustment Board would like to know how the settlement proposed to him compares with that offered his neighbor or competitor. Because the matters revealed to a Board are given in confidence, it is not at liberty to discuss with contractors the affairs of other contractors. A contractor sometimes thinks a Board has accorded him unfair treatment, because he has heard of companies that seemed to have fared better than he. On one occasion a contractor brought to a meeting with his renegotiating board a list of a dozen contractors which, it had been publicly reported, had been renegotiated with results therein indicated. Seven of the twelve had, at that time, not yet met with a price adjustment board!

Many persons on the government side of the table would welcome the right to reveal the facts underlying the settlements proposed to contractors, and the bases upon which they were developed. They believe that a contractor would have a different attitude toward a proposal made him, if he could compare it in detail with those made to some of his competitors. Until, either by law or by common consent of contractors, Price Adjustment Boards are permitted to release the facts underlying settlements with each contractor renegotiated, secrecy with respect to the facts of specific renegotiations must prevail.[10]

EXCESSIVE PROFITS AND INADEQUATE WORKING CAPITAL

"How am I ever going to pay this amount?" is a question often asked by contractors who have received a proposal by a Price Adustment Board. "You tell me I have made excessive profits, but where are they? Three years ago I had a current ratio of 5 to 1; now I am doing five times as much business as I did in 1939, and my current ratio is 1.1. to 1. With all my war business I'm worse off than I was before the war."

The problems of currently financing a rapidly expanding volume of production are not to be taken lightly. Even when collections for goods delivered are received promptly, the need for meeting payrolls, paying for materials, parts, subassemblies and supplies on time, in order not to lose discounts, providing for taxes and other expenditures, when their total increases at a faster rate than the receipts from deliv-

[10] An erroneous impression has perhaps prevailed concerning secrecy and disclosure of renegotiation results. The restrictions on the disclosure of the results of a partciular renegotiation proceeding is, for the most part, limited to government representatives. The manufacturer whose contracts have been renegotiated is under no obligation to keep silent with respect to the settlement made with him, except that for military security purposes, he may not disclose information concerning individual contracts with respect to which he is otherwise already restricted. For the same reason, in some cases it may be improper for him to disclose the gross amount of renegotiable business done. A contractor who compares his own settlements with published results of earnings after renegotiation should be sure, however, that the latter relate solely to the allowed return on renegotiable business and do not include the results from operations which are beyond the scope of the Price Adjustment Boards. A company, for example, which was allowed a profit before taxes of ten per cent on adjusted renegotiable sales representing approximately one-half of its volume, and had a profit before taxes of thirty per cent on the other half of its sales not subject to renegotiation, will show a total net profit after renegotiation, expressed as a percentage of sales, much greater than that of a company allowed a profit of twelve per cent of adjusted renegotiable sales which represented one hundred per cent of its business.

eries, requires constant attention and application of great ingenuity and extreme vigilance to keep a reasonable bank balance. When in addition, a company uses its own funds to provide additional facilities, its financial condition may become really uncomfortable. The Boards approve of the efforts of contractors to finance their war production without borrowing, either from private or government sources. Nevertheless, they recognize that the manner of utilizing the funds acquired through the realization of profits is a matter quite apart from the amount of the profits realized. Excessive profits are profits which should never have been received. To the extent that they have been received a contractor is, in effect, borrowing from the government without interest. In private operations, to expand his plant to handle contracts from which he expects to make a profit he would expect to use his credit, if his own funds were insufficient for the purpose. The same point of view should prevail in his dealings with the government, particularly when the government is so willing to assist him, through its V-loan provisions, and in other ways, to obtain the funds required to finance his war production. The Boards are glad to render whatever aid they can to help a hard pressed contractor to obtain the credit necessary to enable him to carry out his contracts and to refund excessive profits but they do not believe that the contractor who has been inadequately financed and is therefore in serious financial difficulty should be allowed to make and keep excessive profits which he would not be allowed to have if he had been adequately financed. Whether he can pay it back and when are questions quite apart from the one as to whether he has made excessive profits.

CONCLUSION

The Renegotiation Act is a war-time measure which is being administered by persons experienced in business and industry who have no desire to see it develop into a permanent part of the federal statutes. As long as the war lasts and the act stands, the recapture of excessive profits from war production will be an essential part of the task imposed upon the Price Adjustment Boards. The real success of the Act lies, however, in the utilization of the data supplied them by contractors to secure more reasonable prices on future contracts. That the Act is accomplishing this purpose both procurement officers and contractors are in a position to bear witness. It seems highly probable that refunds of excessive profits based on 1943 business will be required of a smaller number of contractors than was the case with respect to 1942 business. As for the war production of 1944, the problem of renegotiation should be greatly simplified. This does not mean that it will be unnecessary to require contractors to continue to furnish the Boards with financial data of the types heretofore requested, although much of the information needed in connection with their first renegotiations they will not have to supply for subsequent ones. It does mean that such data will reveal no excessive profits on war business in an increasing number of cases because procurement officers are so benefitting from the work of the Price Adjustment Boards that they are now able to secure prices on prime contracts and to bring about reductions in prices of subcontractors which are much less likely to yield excessive profits than those negotiated during the early days of the defense and subsequent war program.

ADMINISTRATIVE MACHINERY AND PROCEDURES FOR RENEGOTIATION

LT. COL. PAUL B. BOYD*

ADMINISTRATIVE AUTHORITY AND DELEGATION†

The Renegotiation Act,[1] effective April 28, 1942, as originally enacted, authorized and directed the Secretary of War, the Secretary of the Navy, and the Chairman of the Maritime Commission, whenever in their opinion excessive profits have been realized, or are likely to be realized, from contracts with those agencies or from any subcontract thereunder, to require the contractor or subcontractor to renegotiate the contract price, with some exceptions. Provision was also made for withholding and recovering payments, for the insertion of renegotiation clauses in contracts, exclusion of certain costs, and related matters. Subsequently, the scope of the statute was broadened to include contracts and subcontracts of other agencies[2] procuring war materiel and services: the War Shipping Administration (by Executive Order of September 16, 1942); the Treasury Department (by Revenue Act of 1942, October 21, 1942); four subsidiaries of Reconstruction Finance Corporation, namely, Defense Plant Corporation, Metals Reserve Company, Defense Supplies Corporation, and Rubber Reserve Company (amendment of July 1, 1943). Renegotiation of contracts or subcontracts of the Treasury Department and these other Governmental Agencies was made retroactive to April 28, 1942. The authority for renegotiation and redelegation was accordingly conferred on the War Shipping Administrator, the Secretary of the Treasury, and Board of Directors of each of the four Reconstruction Finance Corporation subsidiaries.

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† While this article was in process of revision, the pending Revenue Bill of 1943 was introduced in Congress (Nov. 18, 1943), passed by the House, amended in Senate Committee, not yet introduced on Senate floor. The Bill, especially as amended by the Senate Finance Committee, contains provisions substantially affecting renegotiation in many respects. With respect to its possible effect upon renegotiation machinery and procedures, however, it is believed that its provisions are not such as to warrant specific discussion in this article. For a general discussion of the pending Bill the reader is referred to the concluding article in this symposium by Jules Abels. [ED.]

[1] 56 STAT. 245, 41 U. S. C. A. note prec. §1 (Supp. 1942). The original Act, Sec. 403 of the Sixth Supplemental National Defense Appropriations Act, 1942, approved April 28, 1942, has been since amended by: 56 STAT. 798, 982, 50 U. S. C. A. §1191 (Supp. July 1943, Appendix) (Sec. 801 of the Revenue Act of 1942, approved October 21, 1942); Pub. L. No. 108, 78th Cong., 1st Sess. (July 1, 1943) (Sec. 1 of the Military Appropriations Act, 1944); Pub. L. No. 149, 78th Cong., 1st Sess. (July 14, 1943).

[2] *Supra* note 1.

In conformance with the authority granted under the Act, as amended, delegations of authority were made for the proper administration of renegotiation. The Secretary of War has delegated all the authority and discretion conferred upon him under the Act to the Under Secretary of War. Reserving to himself the right to approve personally all unilateral determinations and to approve revisions in the policies, principles and procedures established for renegotiation, the Under Secretary has delegated all other authority and discretion conferred upon him to the Commanding General, Army Service Forces, for the administration of renegotiation within his command.

The Commanding General, Army Service Forces, has created the Renegotiation Division to function under the Director of Materiel and has established within the Division the War Department Price Adjustment Board to serve in an advisory capacity to the Director of the Division. He has conferred all powers delegated to him under the statute to the Chairman of the Board, who serves also as Director of the Renegotiation Division. The Under Secretary conferred upon the Commanding General, Army Air Forces, authority for the administration and conduct of renegotiation within his command and directly delegated to the Chairman of the Board the responsibility for formulating policies and procedures for renegotiation in the Army Air Forces.

In accordance with these delegations of authority, the Commanding General, Army Service Forces, and Commanding General, Army Air Forces, have authorized and directed the Chief of the Army Technical Services and Assistant Chief of the Air Staff, Materiel, Maintenance and Distribution, to organize the necessary Price Adjustment Sections for the conduct of renegotiation with contractors assigned to their commands. Authority has also been delegated to commanding generals of the United States Armed Forces in Alaska and outside the continental United States to conduct renegotiation with respect to contracts entered into pursuant to their respective authorities or assigned to them for administration.

The Secretary of Navy has conferred his authority for renegotiation on the Under Secretary of Navy who in turn has created the Navy Department Price Adjustment Board. In like manner Price Adjustment Boards have been created by the Chairman of the Maritime Commission, Secretary of the Treasury, and War Shipping Administrator. One board, called the Reconstruction Finance Corporation Price Adjustment Board, has been established by the Boards of Directors of the Defense Plant Corporation, Metals Reserve Company, Defense Supplies Corporation and Rubber Reserve Company.

General Administrative Machinery

War Department

Renegotiation Division and Price Adjustment Board. By means of delegations of authority from the Under Secretary of War through the Commanding General,

Army Service Forces, for the Army Service Forces, and directly for the Army Air Forces, substantially all the authority conferred upon the Secretary of War under the Act has been delegated to the Chairman of the War Department Price Adjustment Board. The Chairman, accordingly, has been given full power to execute all voluntary agreements without review by higher administrative authority, while the right to approve personally all unilateral determinations and to revise the principles, policies and procedures for renegotiation is reserved to the Under Secretary of War.

The Chairman of the War Department Price Adjustment Board, subject to the limitations above set forth, has also been empowered to establish the policies, principles and procedures to be followed in renegotiation, assist the Technical Services and Army Air Forces in the organization of personnel and conduct of renegotiation, to review agreements and settlements concluded in the War Department and to exercise these powers through any designated member of the Board or through the staff of the Renegotiation Division.

As the result of these delegations, the War Department Price Adjustment Board, as the supervisory and coordinating agency for renegotiation within the War Department, functions through the Renegotiation Division in establishing, with the approval of the Under Secretary of War, principles, policies and procedures for renegotiation, in assigning cases to and assisting the Technical Services and Army Air Forces in their conduct of renegotiation, in the renegotiation of impasse cases and in the direct renegotiation of any company where unusual matters of policy, size of company or volume of contracts make such action advisable.

In the performance of these functions, the Renegotiation Division has been organized into the following Branches: Administrative and Control, Assignments, Renegotiation, Field Operations, Settlement, and Technical Information.

The Administrative and Control Branch has the responsibility for routine operation in the performance of the Division's functions and for evaluating the organization, methods and procedures of the Division. In addition, this Branch has charge of both military and civilian personnel, correlates the renegotiation activities of the various elements in the War Department, maintains statistical records and supervises the codification and dissemination of policies and procedures adopted.

With the consent of all the Governmental Departments and Agencies having renegotiation authority, the Assignment Branch of the Division is also known as the Departmental Assignment Board and handles assignments of all renegotiation cases among the renegotiation agencies. Functioning through three sections, the Examination, Assignments and Classification Sections, the duties of this Branch are to originate and stimulate the reporting of names of contractors subject to renegotiation, to examine available information for the purpose of either assigning contractors and subcontractors for renegotiation or screening out cases where excessive profits obviously do not exist, to classify contractors according to their products or services for assignment and to assign the contractors to the appropriate

Price Adjustment Board, and within the War Department to the appropriate Technical Service or to the Army Air Forces.

Functions of the Renegotiation Branch of the Division are to assume responsibility for and promptly to conduct and complete renegotiation with the officers and representatives of the contracting companies assigned to the Renegotiation Division, recommending settlements in connection with these renegotiations.

The Field Operations Branch evaluates and checks the renegotiation activities of the Technical Services and Army Air Forces as to organization, procedure and personnel and assists the field sections in obtaining and training competent staffs.

The Settlement Branch of the Division has three sections devoted to final review and completion of renegotiation cases. The Financial Review Section has the duties of reviewing the financial aspects of all settlement agreements to determine their fairness, consistency with agreements in similar cases and their conformity to Board approved policies and procedures, and of recommending action thereon to the Chief of the Division and Board. The duties of the Legal Review Section of the Settlement Branch are to secure approval and execution of agreements embodying settlements by the Board, supervise the Financial Review Section and to secure approval by the Board of all agreements reached by the Renegotiation Division and recommended by the other Departments and Services. The Processing Section functions to secure execution on behalf of the Government of agreements receiving Board approval and to distribute to the proper parties executed and conformed copies of all such agreements.

The Technical Information Division establishes and maintains relations with the press, publications and trade associations for the dissemination of information concerning renegotiation and the policies and procedures related thereto, clears prepared papers or speeches through appropriate channels, encourages and develops opportunities for the public discussion of renegotiation by members of the Board and of Price Adjustment Sections of the Services.

The War Department Renegotiation Division and Price Adjustment Board are located in the Pentagon building in Washington. As of September 13, 1943, the total personnel was 175 and of this number 109 were stenographers and clerical assistants. Of the remaining staff of 66 specialists, there were 23 Board members, administrative officers and chiefs of divisions, 15 negotiators and corporate analysts, 5 handling legal matters, 5 cost analysts and statisticians and 18 specialists in miscellaneous categories. Forty-eight Division members were military officers and the remainder were civilian personnel.

Members of the Board are appointed by the Commanding General, Army Service Forces, with the approval of the Under Secretary of War and include the Chairman of the Board, the Vice Chairman, serving as Acting Chairman in the absence of the Chairman, two staff members of the Renegotiation Division, and a representative of the Chairman of the War Production Board. A member of the Navy Department Price Adjustment Board sits with the War Department Board.

The members of the Board are business men with a long record of successful business experience. The various technical members of the staff have been chosen with regard for their particular qualifications and their past record in business. It is noteworthy that these technical representatives, which is also generally the case with the Price Adjustment personnel in the other Departments, in the Technical Services and in the Army Air Forces, are without exception from private business, considering their renegotiation work as a patriotic contribution during the present emergency and desiring to return to their private business activities when the work is completed.

Price Adjustment Sections. In accordance with the powers delegated to him, the Commanding General, Army Service Forces, redelegated to the Chief of each Technical Service the authority to create, with the advice of the Price Adjustment Board, the necessary Price Adjustment Sections to conduct the renegotiation of contractors assigned to each respective Service. Similar powers were conferred upon the Assistant Chief of the Air Staff, Materiel, Maintenance and Distribution, for the Army Air Forces, with respect to cases coming under its jurisdiction.

Accordingly there has been established a Price Adjustment Section in each of the Technical Services of the Army Service Forces and in the Army Air Forces. The Army Service Forces has Sections in the technical services of Chemical Warfare, Engineers, Ordnance, Quartermaster, Signal Corps, Surgeon General, and Transportation. With the exception of the Price Adjustment Section of Chemical Warfare, located in Baltimore, the main Sections of the other Technical Services are located in Washington. Headquarters for renegotiation in the Army Air Forces is shared by Washington and Wright Field, Dayton, Ohio. Wherever required, District Price Adjustment Sections have been established by the Services and the Army Air Forces at procurement centers, and this decentralization allows renegotiation to be conducted close to the location of the company involved.

The Price Adjustment Sections are required to observe the principles, policies and procedures prescribed by the Board, to establish and maintain appropriate procedures to assure uniformity of approach and result and to preserve adequate records showing the basis for settlement and the factors considered in determining the existence or non-existence of excessive profits. The basic principles and policies have been set forth in a joint statement of the War, Navy and Treasury Departments and Maritime Commission published on March 31, 1943. The *War Department Manual for Renegotiation*[8] embracing this information as well as detailed instructions on all matters relating to organization procedures and policies, has been available since August 15, 1943, for the guidance of the Sections. While the conduct of renegotiation conforms generally to the patterns and standards prescribed, the machinery and procedures developed have necessarily been adapted to the peculiar needs and conditions existing in each Service.

[8] While this *Manual* has been reserved for the internal use of the agencies engaged in renegotiation, it is anticipated that the new *Joint Renegotiation Manual* will be available to war contractors and the public in the near future.

Authority has been delegated to the Chief of each Service to execute renegotiation agreements for all the Departments, without further review or approval, where a contractor's total sales, both renegotiable and non-renegotiable, do not exceed $10,000,000 for the fiscal year under review. The Chief of each Service may delegate within his organization similar authority to conclude agreements where total sales are not over $5,000,000. All other agreements reached are subject to review by the Board and approval by the Under Secretary of War on behalf of the Government.

On September 13, 1943, the personnel of the Price Adjustment Sections in both the Army Service Forces and Army Air Forces totaled 1,644, with 950 serving as technical specialists and the balance of 694 as clerical aids. The technical staff embraced 156 in the category of local board members and chiefs of offices and sections, 312 negotiators and corporate analysts, 35 performing legal functions, 356 cost analysts and statisticians and 91 financial reviewers and other specialists. Military personnel comprised 224 and civilian personnel 1,420 of the entire force.

Before continuing with a discussion of the particular machinery and procedures within the different Departments, Agencies, and Services, a broad survey of general procedures is indicated at this point.

GENERAL PROCEDURES[4]

Assignment

All assignments for renegotiation, on behalf of all the interested Departments, are made by the Clearance and Assignment Officer of the Departmental Price Adjustment Boards operating through the medium of the Assignment Branch of the Renegotiating Division of the War Department. The policy, as far as practicable, is to assign all contractors producing the same or similar products to the same Department or Service. Accordingly a particular contractor will ordinarily be assigned to the Department or Service having the principal interest in the type of products and services furnished by the contractor even though that Department or Service may not have a predominant interest in the contracts being currently performed by the particular contractor.

A contractor must be officially assigned by this Branch before renegotiation of his excessive profits may be initiated. Any Department or Service may request immediate assignment of any case without assembling preliminary information whenever it deems such action necessary or appropriate. The Services are required to secure information from their contracting officers as an aid to the Assignment Branch in recommending contractors for renegotiation, especially in cases where scandalous conditions exist, where practices exist which might be a discredit to the War Department or the contractor, where profits reflect high costs by comparative standards, and where excessive profits are known to exist.

[4] This discussion is devoted primarily to the procedures generally followed in the War Department's renegotiation.

It is the duty of the Assignment Branch, on behalf of all the Departments and Services, to identify companies which may be subject to renegotiation. For this purpose information is obtained from all available sources. Under authority conferred by the Renegotiation Act, and by arrangement with the Bureau of Internal Revenue, summary transcripts of income tax returns, containing pertinent information relating to sales, profits and renegotiable business, are made available to this Branch for review.

Where it appears that excessive profits may have been realized, the form letter of preliminary inquiry, requesting information necessary to determine whether or not assignment should be made, is forwarded to the company.[48] Accompanying this letter is the appropriate report form for either a supply or construction contractor, a copy of the statute and a statement of non-applicability under the act for use wherever justified. Upon return of this information, the facts of the case are reviewed independently by two analysts, one of whom is usually a representative of the Department to which the contractor would ordinarily be assigned. Where renegotiation is in order, the case is immediately assigned to the proper Department or Service. Assignment is made without recourse to the letter of preliminary inquiry where available information clearly indicates the necessity for renegotiation and the particular agency to handle the proceedings.

Assignment of a case to a particular Department or Service is final for the fiscal year under review, unless subsequent developments indicate the advisability or necessity of reassignment to another Department or Service or the cancellation of the assignment. In general, no reassignment is made after conferences with the company have commenced. Ordinarily the Board authorizes reassignment of a

[48] The information requested of a supply contractor in anticipation of the renegotiation of his 1942 business included complete financial data (balance sheets and related income and surplus statements, including available detailed audit reports of his independent public accountants) for his fiscal years 1941 and 1942 and the elapsed portion of 1943; the nature of his prewar business, the extent and date of conversion to war work and a description of peacetime and wartime products; affiliation with other concerns, including names and addresses of affiliates, volume and extent of affiliation or relationship, character of affiliates' business and an expression of opinion regarding the desirability of treating the contractor and his affiliates on a consolidated basis for purposes of overall renegotiation; a segregation of sales between renegotiable and non-renegotiable business and a further analysis of renegotiable sales into direct (based on prime contracts or purchase orders) and indirect (based on subcontracts, purchase orders, etc.); an estimate of the percentage of total renegotiable business (both direct and indirect) ultimately billed to each of the Departments and Army services; compensation in excess of $10,000 paid to officers and employees during 1940 and subsequently; government assistance at the end of the latest complete fiscal year, including "V" Loans and facilities furnished or financed by the Government; a reconciliation of financial data submitted with those reported for Federal tax purposes, and an explanation of charges for post-war conversion, inventory shrinkage or other contingencies.

Construction contractors were requested to furnish less of the overall financial data asked of supply contractors but more specific contract information, such as the contract number of each contract and subcontract; the type of each contract (advertised or negotiated; lump sum, unit price or cost-plus-a-fixed-fee; prime or subcontract; architect-engineer, construction or combination); the name of the Department or Agency with which each prime contract was made; the name of the prime contractor and Department or Agency with which each subcontract was made; contract price, including amendments, and for cost-plus-a-fixed-fee contracts, a separation of the price into estimated cost, fee and final cost; a brief description of the nature and location of the work; the approximate per cent of work subcontracted to others; and a classified summary of profit and loss on all contracts and subcontracts completed during the latest complete fiscal year.

case if it appears that the contractor should be renegotiated concurrently or on a consolidated basis with another contractor already assigned to another Department or Service or if the nature of its products or its corporate relationships or similar considerations so require. The Board will cancel an assignment where a contractor is exempt under the act or where it clearly appears that excessive profits have not been realized.

Renegotiation

While cases may be assigned directly to the War Department Price Adjustment Board for renegotiation, the great majority of War Department renegotiations are handled by the Price Adjustment Sections of the Technical Services and Army Air Forces. The Services generally follow identical patterns of procedure in conducting renegotiations.

The initial step in renegotiation proceedings is the assignment of a case to a Section of one of the Services, and with the reassignment of the case to a negotiator in the Section for handling. As far as possible, a negotiator is assigned contractors engaged in similar industries or types of production in order to allow him to become specialized in a given field. A negotiator is not assigned a company in which he is directly or indirectly interested.

The original assignment from the Board indicates the other Departments or Services which are interested and which have been notified of the assignment, and it is the duty of the negotiator to advise any other Department or Service which is later found to have an interest in the case. As agreements made by a Department or Service with a contractor assigned to it are binding upon all other Departments and Services, representatives of any interested Department or Service may confer with the negotiator and acquaint him with all information necessary to a proper determination in the case. Unless specifically requested, however, no other Service or Department is obligated to furnish information, and similarly the negotiator is not obliged to furnish notice of meetings or other information to an interested Department or Service, except in the case of the Navy Department which has requested the renegotiating Service to submit copies of the minutes of all meetings relating to a case in which it has an interest.

The negotiator is responsible for the conduct of renegotiation proceedings and is assisted by a cost analyst. The cost analyst is responsible for assembling and checking the accounting information required and for advising on the technical financial matters involved in the renegotiation. Necessary information may be obtained by correspondence, conference, visit to the contractor's office or other available method. There is now available the Contractor's Information Form for the convenience and guidance of the contractor in furnishing the desired information.

It is the policy to collect all possible information prior to the first meeting with the contractor so that actual meetings may be devoted to evaluating these data. In this way an agreement may be reached with the minimum of delay and incon-

venience to the contractor. In assembling and preparing the information every effort is made to prevent duplication of work and delay. Reports of independent public accountants are obtained wherever available and the cost analyst refrains from auditing the contractor's books or examining in detail the methods of segregating renegotiable sales unless exceptional conditions require this action. All information is prepared for the dual purpose of conducting the renegotiation and of providing material, upon request, to aid procurement officers in establishing sound contract prices.

Meetings with contractors are ordinarily held in the office of the Section conducting the renegotiation and are attended by at least two Government representatives, including the negotiator and cost analyst. Whenever personnel allows, panels for handling conferences are established. While an interested Department or Service may have a representative present, every effort is made to hold down the number of Government representatives at any meeting and usually only the negotiating Service is represented.

At the first meeting with the contractor, the negotiator explains the objects of the renegotiation statute and its underlying philosophy and policies. If the necessary information has not already been obtained, the negotiator explains what additional data are required and stresses the value of submitting the information promptly and in good order to simplify and expedite the renegotiation procedure. Following the first conference the negotiator prepares the minutes of the meeting and the cost analyst, if he has not already done so, submits his report in conformance with a prescribed form. Subsequent meetings, if necessary, in the pattern outlined above, are conducted in an effort to evaluate all aspects of the case and arrive at an agreement as to the amount, if any, of excessive profits involved. Field Sections operate in similar manner and maintain constant contact with the main Section offices both for the assistance that may be rendered and for the purpose of achieving uniformity in result.

Agreements

Subsection (c)(4) of the Act provides that the proper authority may make final or other agreements with a contractor for the elimination of excessive profits and for the discharge of any liability thereunder, and provides that any such agreement shall be final and conclusive according to its terms. There are three general types of agreements: the interim agreement, the final agreement and the clearance notice.

Interim agreements are used when there is a temporary adjustment pending further consideration of the information submitted or to be submitted and where it is contemplated that there will be further renegotiations before a final settlement is reached. Such an agreement may be in any form provided it states that the agreement is not final, does not prejudice subsequent determination in the case, and that no amount previously paid to the Government as a result of any renegotiation shall be refunded as the result of any subsequent renegotiation.

Final agreements are used to provide for clearance from liability under the act whenever a contractor has negotiated in good faith for a specified period and agreed to eliminate excessive profits for that period. Such agreements must be related to the statute and follow the general structure of the standard form of agreement. Two forms are available, one to be used when the fiscal year under review has closed and actual figures are available and the other where the year is still under review and actual figures are not yet available. These final agreements are subject to reopening by the Under Secretary of War only in the case of fraud or in the event that actual figures are at material variance with estimated figures which may have been used.

The final agreement contains a complete statement of all important factors involved in the settlement including the amount agreed upon as representing the aggregate excessive profits realized or likely to be realized from the contracts or subcontracts for the fiscal period under review, specific information concerning the contracts or subcontracts affected showing the price reductions called for under future deliveries, a full description of the dates and amounts and method of payment of all cash refunds, and if relating to a past period for which Federal tax returns have been filed, a statement of the tax credit to which the contractor is entitled under Section 3806 of the Internal Revenue Code.

Clearance notices follow two standard forms, one to be used when the contracts of the Reconstruction Finance subsidiaries are included in the renegotiable business considered and the other in all cases in which the determination is made prior to the inclusion of these contracts.

All agreements are signed on behalf of the contractor by the owner, a partner or an authorized officer and in the case of a corporation are accompanied by an attested copy of a resolution of the Board of Directors authorizing its execution. Dependent upon the signing authority as delegated, the agreement or clearance notice will be approved and executed on behalf of the Government by the Service which conducted the renegotiation or submitted to the Board for approval and for execution by or on behalf of the Under Secretary of War, acting for all the interested Departments and Agencies of the Government.

In addition to the preparation of the formal agreement or clearance notice, it is required that each Section prepare also a report of settlement explaining and justifying the terms of the settlement and containing sufficient information to provide both a basis for approval by the authorities whose approval is required and a permanent record for future justification of the decision reached. There are two standard forms, the short form used in case of clearances and where excessive profits agreed upon do not exceed a certain stipulated and relatively low percentage return on volume of renegotiable business and the long form used in all other cases. Each standard report is divided into two parts consisting of a narrative summary in topical form and financial data in tabular form, with the narrative portion developing all general information relating to the background of the case,

business of the contractor, price and production record, governmental financial assistance, and including a clear, factual and comprehensive statement of all important financial matters, and the recommendations with respect to the amount, basis and functioning of the settlement.

Upon the approval and execution of renegotiation agreements, a definite pattern of procedure is followed in administering the terms of the agreements. In both cases when a Service has conducted renegotiations and concluded the agreement and where the Board has performed these functions, the administration of the agreement is handled by the Fiscal Branch of the Service having the predominance of interest in the case. It is the duty of the Fiscal Branch to verify compliance by the contractor with all the provisions of the agreement and to see that all required payments are made. All checks submitted by the contractor in payment of refunds are forwarded to the nearest Fiscal Office involved, which in turn covers the payment immediately into the Treasury as Miscellaneous Receipts for credit to the account of "Excessive Profits on Renegotiation."

Refunds and Price Reductions

The act authorizes the elimination of any excessive profits realized or likely to be realized by reductions in the contract price, by withholding from amounts otherwise due to the contractor or subcontractor any amount of such excessive profits, by directing a contractor to withhold such amounts from the subcontractor, and by recovery from the contractor or subcontractor, through repayment, credit or suit, of excessive profits actually paid to him.

In renegotiation for a prior fiscal period the elimination of excessive profits will usually be made in the form of a refund, and this refund may be made by the contractor in a single payment or in installments. Ordinarily, when excessive profits are eliminated by installment payments, the final installment must be made not later than the end of the fiscal year following that to which the renegotiation relates and the installments must be arranged so that total payments required prior to each quarterly tax payment date are at least equal to the Federal income and excess profits taxes which would have been paid on the excessive profits eliminated. In cases of undue hardship, certain exceptions may be permitted for limited extensions of time.

Whenever statutory renegotiation for a past period reveals that the contractor's current prices are yielding excessive profits, it is the obligation of the interested Price Adjustment Section to obtain or provide for price reductions on future deliveries under the renegotiated contracts and subcontracts. Only in this manner can the renegotiating agency complete its duty in eliminating profits likely to be realized. Determination of the price reductions to be made are dependent upon the same factors in the main as were originally considered in the renegotiation dealings.

Various methods are used in effecting price reductions on future deliveries. Where a relatively few large contracts represent a substantial portion of the con-

tractor's business and these contracts are with the Service conducting the renegotiation, the unit prices may be reduced directly in the renegotiation proceedings, and provided for in the agreement. In the case where a relatively small number of products make up a predominant portion of a contractor's business, the prices of the products may be adjusted to a fair basis and the facts included in the renegotiation agreement.

Where it is not feasible to adjust the individual unit price, a flat percentage reduction on all renegotiable sales may be required or the contractor may be obliged to agree to make reductions on outstanding contracts in a minimum dollar amount. Where it is necessary to close a renegotiation promptly and time does not permit the proper determination of price reductions, the renegotiation agreement may provide that the contractor agrees promptly to investigate the costs involved and as rapidly as practicable effect appropriate price reductions. Actual adjustment in the contract prices currently is required and failure to comply is taken into consideration in subsequent renegotiations.

In effecting price reductions, consideration is given to the contractor's statements and estimates on the costs involved, to all available information obtained through renegotiation or otherwise and to the recommendations and facts presented by the procurement staff. Provisions in the agreement for reductions in prices must state clearly that such action does not serve as a clearance for those prices or to preclude subsequent renegotiation of the contract prices.

Impasse

Refusal to Submit Information. Two possible situations may interfere with renegotiation procedure. Either a contractor may refuse to submit the required information or be unwilling to agree to a settlement considered fair by those conducting the renegotiation. In covering the first situation, the Renegotiation Act provides that the services of the Bureau of Internal Revenue shall be available for the purposes of making examinations and determinations with respect to excessive profits and further that the Secretary of each Department shall have the right to demand of any contractor who holds contracts subject to renegotiation, under penalty of law, statements of actual costs of production and such other financial information as may be required. Title XIII of the Second War Powers Act, 1942, also gives the Government the right to inspect and audit the books of any contractor holding an order placed in furtherance of the war effort.

Unilateral Determination. Subsection (a)(3) of the Renegotiation Act provides that the term "renegotiation" includes the refixing of the contract price by the Secretary of the interested Department. Giving recognition to cases where contractors may seek to postpone or delay renegotiation in the expectation and hope of relief from Congress, the Under Secretaries of War and Navy in a joint statement of July 23, 1943, stated that the several Departments, being under obligation to continue renegotiation under existing law, should refer such cases immediately to

the Under Secretary of War or Navy for final determination of excessive profits realized or likely to be realized by the contractor under his contracts.

If, after reasonable effort, the Service is unable to obtain an agreement by the contractor to a settlement considered fair by the Service, the impasse case is submitted promptly to the War Department Price Adjustment Board. If the Board is unable to come to an agreement with the contractor, the case is finally referred to the Under Secretary of War for appropriate action under the Act.

In the event of the necessity for a unilateral determination, the Under Secretary first makes a final determination of the amount of excessive profits for the fiscal year involved; secondly, may make such supplemental audits and investigations as might be required to afford a basis for final determination of the amount of the excessive profits realized since that time; thirdly, may effect a reduction of prices on all outstanding continuing contracts to the extent necessary to eliminate excessive profits likely to be realized in the future; and finally may recover any excessive profits determined to have been realized by withholding sums due on his prime contracts and, if the situation called for such action, may direct his prime contractors to withhold sums due on their subcontracts until all excessive profits had been eliminated.

The War Department has taken the position that it will employ every authorized method of eliminating excessive profits. The contractor, subjected to a unilateral determination, is entitled to obtain a judicial review of the War Department's action, if he wishes to do so, by suing for the recovery of any amounts withheld.

Right of Review. While it is clear that a contractor or subcontractor who concludes a voluntary agreement based upon renegotiation does not have access to the courts for relief, it is equally clear that a contractor or subcontractor subject to a unilateral determination in a renegotiation settlement does have a right to judicial review.

The statutory history of the Renegotiation Act shows that such judicial review was contemplated. Section 403(c)(3) of the statute, as originally introduced into the Senate, prohibited suits to recover from the United States any amount withheld from a contractor in renegotiation. As a result of objections raised, no such provision became law. The Congressional Record reveals that the lawmakers considered such a provision unfair.[5]

Controlling judicial principles and decisions are authority for the right to judicial review in the event of a unilateral determination. The right of judicial review does not rest upon any prescribed statutory grant. As a consequence of these factors, it is clear that Congress intended to permit judicial review with respect to unilateral determinations under the statute and that under well-settled principles of law a right to such review exists.[6]

[5] 88 CONG. REC., April 23, 1943, at 3765-6.

[6] A concise legal brief in support of the conclusion that "it cannot be disputed, first, that Congress intended to accord judicial review under the renegotiation statute, and second, that under well-settled

Coordination

Ever since the passage of the Renegotiation Act, there has been a deliberate and concerted effort to coordinate the policies and procedures of renegotiation between and within the different interested agencies, of which the recent establishment of the Joint Price Adjustment Board was the logical culminating development. Even before this development, the Price Adjustment Boards of the various agencies have acted in the formulation of policies and procedures in renegotiation and price adjustment in close relationship with the boards of the other representative agencies, to the end that a consistent approach and a consistent uniformity in renegotiation might be maintained. Although there was naturally at the outset some divergence in the policies of the Boards, the elements of difference have in every important respect been fully reconciled. The Boards are now operating under the declaration of Purposes, Principles, Policies and Interpretations embodied in a joint statement, published March 31, 1943, of the War, Navy and Treasury Departments and Maritime Commission, and in conformance with the *War Department Manual for Renegotiation* issued on August 15, 1943.

Even before the creation of the Joint Board, uniformity among the Boards was maintained through a constant liaison and through joint meetings of the chairmen of the Boards, and of the Under Secretaries of War and Navy with representatives of the Price Adjustment Boards, by attendance at meetings of each of the Departmental Boards of the representative of the Chairman of the War Production Board as coordinating member at the meetings of each of the Boards and by the usual attendance of a member of the Navy Board at the meetings of the War Department Board.

Under date of September 24, 1943, a Joint Price Adjustment Board was created by joint action of the Secretaries to which they delegated authority and discretion as follows:

(a) To formulate and adopt statements of purposes, principles, policies, and interpretations under the statute which shall be binding on the Departments.

(b) To define, interpret and apply by joint regulation the exemption specified by the statute relating to the product of a mine, oil or gas well or other mineral or natural deposit or timber.

(c) To exempt from some or all of the provisions of the statute general classes or types of contracts, and to formulate standards for the exemption of such contracts.

(d) To determine whether any contractor shall be required to renegotiate for any fiscal period the contract price under some or all of his contracts subject to renegotiation under the statute.

(e) To assign any contractor to any Department for determination whether excessive profits have been or are likely to be realized from some or all of its contracts subject to renegotiation under the statute.

(f) To prescribe by joint regulation the form and details of the financial statements contractors may file, and the form, time and manner of giving the notice to which they

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principles of law a right to judicial review exists under such statute," see *Hearings before the Committee on Naval Affairs pursuant to H. Res. 30*, 78th Cong., 1st Sess. (1943) Vol. 2, pp. 1039-1043.

are entitled, in order to commence the running of the period of limitation after which its contracts cannot be renegotiated.

The Joint Board thus created is composed of the Chairmen of the Price Adjustment Boards of the War, Navy, and Treasury Departments, the Maritime Commission and the Reconstruction Finance Corporation together with a representative of the Chairman of the War Production Board. The establishment of the Joint Board provided a formal procedure in place of the informal cooperation which had been maintained between the several Price Adjustment Boards and the Secretaries in such matters.

Uniformity of approach by the Departments and by various Services and District Boards is fostered and maintained in numerous other ways. Occasional coordination meetings are conducted by the War Department Price Adjustment Board at which all of the Army Technical Services and Army Air Forces are represented. Problems are there discussed, and the Services are kept informed of any new developments in matter of policy or procedure. In turn, the Services communicate to the District Boards all matters which may have any substantial bearing upon the conduct of renegotiation. The War Department Price Adjustment Board from time to time furnishes to the Services instructions and informative material helpful in maintaining uniformity, and the Field Operations Branch of the Renegotiation Division operates to evaluate and check the renegotiation activities of the Technical Services and Army Air Forces as to organization, procedures and personnel and assists the field sections in obtaining and training competent staffs. Members of the Board and of the Staff visit the various District Boards and Sections, while representatives or members of District Boards and Sections likewise frequently confer with the representatives of the War Department Board.

Periodically, every two or three months, there have been held in different cities joint three-day conferences attended by representatives of all the Departmental Boards and by members of the Price Adjustment Sections of the Army Service Forces and of the Army Air Forces and by Board and Staff members of the District Price Adjustment Boards of the Services and of the Army Air Forces. At these meetings price adjustment problems were discussed, illustrative renegotiations conducted, and every means taken to make uniform the understanding and application of the principles and basis of approach in renegotiation among all of those engaged in the administration of the law. A complete record has been taken of important portions of the proceedings and copies distributed to all of the personnel engaged in the work of renegotiation.

Uniformity has likewise been maintained in War Department renegotiations through the review of all War Department cases by the Settlement Branch of the War Department Renegotiation Division. Every case, whether or not within the scope of the delegation of authority to the Services, is reviewed both by the Financial Review Section and by the Legal Review Section of the Settlement Branch.

An analysis and report of each case is made to the Board and consideration is given to any unusual circumstance or to any departure from established policies. If the settlement is not in absolute accord with the policies of the Board, the case, unless within the scope of the delegation of final authority to the Services, is either sent back to the Services for further action or the Board itself may assume jurisdiction to complete the renegotiation. Such action may be taken irrespective of whether it will result in a larger or a smaller recovery, as the Board conceives it to be its duty to administer the law with the same fairness of approach to the contractor as to the Government. If the case is one within the delegation to the Services, then any deviation from the principles established by the Board is at once called to the attention of the Service, and the Service takes such corrective steps as may be necessary to insure uniformity in the future.

As a further element in coordination, special and detailed industry studies have been or are being made, as, for instance, in the brass, steel, textile, rubber and machine tool industries. These studies, completed by experts in the respective fields, make available to the Price Adjustment Boards and to the Services precise and informative data of the utmost significance in renegotiation. The renegotiations of contractors in these, as in other industries, are as nearly as possible conducted by the Department or Service which has the greatest familiarity with the industry involved.

Against the background of the general procedures above discussed, the organization and procedure of the different Departments, Agencies, and Services can now be reviewed.

DEPARTMENTAL ORGANIZATION AND PROCEDURES

War Department

Army Air Forces. Renegotiation functions in the Army Air Forces are performed in the Office of the Assistant Chief of the Air Staff, Materiel, Maintenance and Distribution and in the Materiel Command.

The Assistant Chief of the Air Staff, Materiel, Maintenance and Distribution has delegated authority for the supervision of the principles and procedures in renegotiation to the Control Officer. The staff in the Control Office for renegotiation is the Price Adjustment Branch. The Price Adjustment Branch, located in Washington, reviews and submits to the War Department Price Adjustment Board for approval, cases renegotiated in the District Offices. It also performs a liaison function with the Board and a service function for the Army Air Forces Price Adjustment Sections with the Board, the Technical Services, Army Service Forces and the other Departments of the Government engaged in renegotiation. The Price Adjustment Branch, Control Office, conducts renegotiation only in exceptional cases and in those cases where an impasse has been reached in the District Offices.

The organization of Price Adjustment activities within the Materiel Command is in accordance with the general organization of the Materiel Command for pro-

curement purposes. The headquarters office for renegotiation operations in the Materiel Command is the Price Adjustment Office, Wright Field, Dayton, Ohio. This office coordinates the functions of the field offices and all cases are cleared through the Price Adjustment Office, Wright Field to the Price Adjustment Branch, Control Office, Materiel, Maintenance and Distribution. The Price Adjustment Office, Wright Field, maintains all records and statistics and maintains close liaison with other activities of the Materiel Command, particularly the Procurement Division and the Budget and Fiscal Office. Assignments of cases to the District Offices are made by this office. Renegotiation is conducted by this office in a limited number of cases.

Price Adjustment Sections are established in five of the six Procurement Districts of the Materiel Command to conduct renegotiation with contractors within the area of each such Procurement District.[7]

Each District Price Adjustment Section is headed by a Price Adjustment Officer. There is a Price Adjustment Board in each of the Price Adjustment Sections. While membership on the Board varies, the Chief of each Section is a member along with several other civilian or military members.

Each District Office has a staff of negotiators and a separate Cost Analysis Section. In addition, there is usually a Review Section and a Legal Section whose functions are to perfect the Reports and Agreements as initially prepared by the renegotiator.

As of September 13, 1943, the total personnel engaged in renegotiation in the Air Corps was 390, with 131 of this number assisting in a clerical capacity.

The procedures outlined by the Price Adjustment Board are generally followed in the conduct of renegotiation in the Army Air Forces. However, the organization for renegotiation is not rigid and each District Office is organized along the lines best suited for its functioning in view of the personnel available, office space, geographical location and other pertinent facts.

All dealings with the War Department Price Adjustment Board are had through the Price Adjustment Branch, Control Office, Office of the Assistant Chief of the Air Staff, Materiel, Maintenance and Distribution, with one exception. Assignments are forwarded direct from the War Department Price Adjustment Board to the Price Adjustment Office, Materiel Command, which reassigns the case to the appropriate District Office for renegotiation.

Through procedures established by the District Office, the companies are assigned to Renegotiation Panels which consist of two or three negotiators. One of the members of such a panel is primarily responsible for the completion of renegotiation with the company. The negotiator to whom the case is assigned has discretion in handling the case and in arranging for the renegotiation meetings. It is the policy of the Army Air Forces to visit the plant of each contractor and if possible,

[7] New York, Detroit, Chicago, Wichita, and Los Angeles, for their respective Procurement District. Area Offices at Cleveland, Cincinnati.

to hold one renegotiation meeting at the contractor's office. The negotiator submits the case to the District Board for consideration prior to the submission of a proposal to the contractor and the approval of the Board is then obtained. If an agreement is reached the Renegotiator and Cost Analyst prepare the report in conjunction with the Review Section and the case is then forwarded through Wright Field to the Price Adjustment Branch, Control Office, Materiel, Maintenance and Distribution for submission to the Board.

If the negotiator cannot secure a settlement, the case is reviewed by the District Board and the contractor is afforded an opportunity to appear before the Board. In the event of a further impasse the record is completed, the contractor's objections obtained and the case is forwarded for further action to (1) Wright Field, (2) the Price Adjustment Branch, Control Office, or (3) the War Department Price Adjustment Board.

The District Offices are about to approve settlements finally under delegation. Since delegation has not heretofore been exercised, the proposed procedure is not in full operation. The authority to approve agreements with contractors having sales not in excess of $5,000,000 for the period under renegotiation has been delegated to the District Supervisors of the Procurement District within which the Price Adjustment Sections are located. At the present date, no redelegation has been made by the Assistant Chief of the Air Staff, Materiel, Maintenance and Distribution, of the authority to approve cases finally with contractors having sales in excess of $5,000,000 but not in excess of $10,000,000 for the period under renegotiation.

Chemical Warfare. Renegotiation in the Chemical Warfare Service is conducted through a Price Adjustment Section located at Baltimore. This Section has been organized as a part of the Purchase Policies Branch in the Office of the Chief, Chemical Warfare Service, and reports directly to the Assistant Chief, Chemical Warfare Service for Materiel.

The Cost Analysis Section has been combined with the Price Adjustment Section and the combined sections are organized on the basis of four panels and a Docket and Assignment Unit, operating under the administrative control of the Section Board. One panel handles general cases, while the other three conduct renegotiations on the basis of geographical location, covering cases in the Chicago, Pittsburgh and New York Procurement Districts.

As of September 1, 1943, authority was issued for a staff of 20 officers and 35 civilians, and as of September 13, 1943, the four panels embraced a technical personnel of 18.

The procedures outlined in the Renegotiation Manual are followed. Cases assigned to this Service are first handled by the Docket and Assignment Unit which has the responsibility for obtaining the initial information from the contractor. On the basis of this preliminary information, the company is assigned to one of the panels, depending upon the geographical location of the company's records and home office.

The first meeting is arranged and conducted by the panel itself. In order to expedite processing of pending cases, the panel spends several days each month in the New York, Chicago or Pittsburgh District office, as the case may be, for the dual purpose of establishing closer contact with the Procurement Districts and permitting closer control over the progress of the contractors in preparing and submitting information required for renegotiations.

While all cases handled through September have been submitted to the War Department Board for approval, it is anticipated that the Service will soon exercise its authority to enter into final agreements.

Engineers. Statutory renegotiations are carried out in the Corps of Engineers under the jurisdiction of the Chief of Engineers, who has designated the Price Adjustment Section in the Office of the Chief of Engineers to supervise and coordinate price adjustment activities of the Division Engineers throughout the continental United States.

The Price Adjustment Section in the Office of the Chief of Engineers consists of five units under the direction of the Chief of the Section: the Advisory Board, the Assignment and Distribution Unit, the Cost Analysis Unit, the Legal Unit and a Renegotiation Unit consisting of a group of sub-units. Primary duties of these units are as follows:

The Advisory Board, consisting of a few men of outstanding ability and experience, reviews reports of renegotiation of Division Price Adjustment Sections in cases in which it is incumbent upon the Chief of Engineers to make such reviews, recommends the basis of settlement in each case renegotiated in the Office of the Chief of Engineers and furnishes expert advice on particular matters referred to it.

The Assignment and Distribution Unit handles all matters dealing with the assignment of contractors for renegotiation and the distribution of agreements and clearance notices in conclusion of renegotiation.

The Cost Analysis Unit procures and analyses financial and factual data in the case of contractors assigned for renegotiation in the Office of the Chief of Engineers and prepares a written report embodying its findings prior to the actual renegotiations. In addition, it furnishes expert advice in cost-analysis matters and assists the field sections in these same matters.

The Legal Unit reviews for legal correctness the agreements and clearance notices including renegotiations, prepares instructions for promulgation within the Engineer Department on policy and procedural matters and handles correspondence and furnishes expert advice in regard to such matters.

The Renegotiation Unit is actually a group of units established for two purposes: (1) for liaison with and assistance to field price adjustment sections in certain geographical jurisdictions and (2) for statutory renegotiations within the Office of the Chief of Engineers.

General administrative and personnel matters are under the control of the Executive Officer of the Price Adjustment Section.

Division Price Adjustment Sections, patterned in organization generally after the Price Adjustment Section of the Office of the Chief of Engineers, are located in various cities for the different divisions.[8]

The total staff engaged in renegotiation in this Service as of September 13, 1943, was 585, with 314 of this number in a clerical capacity.

The basis of renegotiation of supply contracts, in the Engineers Department, is exactly the same as in the other Services; however, the Corps of Engineers has a very different method of renegotiation in the cases constituting 80 per cent of its case load, i.e., construction cases. In these instances, renegotiation within the scope of a special delegation of authority may be conducted on a separate or group contract basis or on an over-all-profits basis just like supply contracts. The separate or group contract bases have been evolved to fit the peculiar needs of the construction industry and are designed to relieve the contractor of doubt as to his obligations in the face of renegotiation at the earliest possible moment following completion of a contract, in order that his bank credit and bonding capacity can be maintained at a maximum.

Assignment of construction cases to Division Price Adjustment Sections is made to the section having jurisdiction over the area where the major amount of contract work has been done. In the case of supply contracts, assignment is made to the Division section having jurisdiction over the area in which the contractor's home office is located. The Price Adjustment Section of the Office of the Chief of Engineers retains for renegotiation only those cases where exceptional dollar volume, scandalous profits or unusual policy matters may be involved.

Negotiators in the Office of the Chief of Engineers are responsible for the conduct and completion of renegotiation in their respective assigned cases. The general procedure in such cases entails initial advice to the contractor of the renegotiation, meeting of cost analysts with the contractor for the solicitation of financial and factual data, the request to the Cost Analysis Unit for its report, the study and analysis of the cost analysis report, the meeting with the Advisory Board and participation as a voting member in determining the proposed basis for settlement, the renegotiation meetings with the contractor, the writing of the report of renegotiation and procurement of the executed agreement and the final submission of the case to higher authority.

In addition, negotiators in the Office of the Chief of Engineers maintain liaison with Division Price Adjustment Sections to insure the proper handling by the latter of their cases. In cases renegotiated by Division Price Adjustment Sections, where under procedural rules it is incumbent upon the Office of the Chief of Engineers to approve or disapprove the settlement, the negotiator in the Office of the Chief of Engineers reviews the case in detail and participates as a voting member of the Advisory Board in its over-all review of the case. The negotiator then trans-

[8]Boston, New York, Baltimore, Atlanta, Columbus, Chicago, Omaha, Dallas, San Francisco. Also a sub-office in Portland, Oregon.

mits the case for action by higher authority if the case is approved or instructs the field as need be if the case is disapproved.

Authority for the execution of agreements and issuance of clearance notices has been decentralized to Division Engineers so that approximately 90 per cent of all cases assigned to Division Price Adjustment Sections are fully concluded by those sections.

Ordnance. In order to carry out the responsibilities of the Ordnance Department with respect to renegotiation, there was established within the Legal Branch, Purchase Policy Section, Office of the Chief of Ordnance, a Price Adjustment Unit, and Price Adjustment Section Boards have been established in each of the thirteen Ordnance districts. The Price Adjustment Unit at Washington operates as the coordinating agency for the procedures and policies of the thirteen Boards and as the liaison between these Boards and the War Department Price Adjustment Board.

The functions of each District Board are to conduct or supervise renegotiations with contractors assigned to them by the War Department Renegotiation Division through the Office of the Chief of Ordnance. Conforming with policies established by the Chief of Ordnance and in accordance with the judgment of the District Board where policy is not prescribed, renegotiations may be conducted by either the full Board, by individual members thereof or by negotiators delegated by the Board, provided, however, that all settlements are concurred in by a majority of a panel of three of the Board. A Board usually consists of three members, who are representative citizens and outstanding in the business life of their respective communities.

Each Board is assisted by an administrative unit, comprising such negotiators, analysts, technical and clerical assistants as may be required and by the services of a cost analysis unit established in the Ordnance district office for this express purpose. These staffs, handling the detailed work of financial analysis and preparation of reports and agreements during the course of renegotiation, are composed of experienced business men, accountants, financial analysts and attorneys.

The locations of the thirteen Ordnance Price Adjustment Section Boards are as follows: Birmingham, Boston, Chicago, Cincinnati, Cleveland, Detroit, New York, Philadelphia, Pittsburgh, Rochester, St. Louis, San Francisco, and Springfield, Massachusetts. As of September 13, 1943, the total personnel of these Boards was 372, including 241 technical specialists and 131 clerical assistants.

Renegotiation procedure follows the established pattern. Upon assignment, the Ordnance District Price Adjustment Section Board contacts the contractor requesting the submission of the necessary financial information. The negotiator, handling the case, familiarizes himself with all the pertinent facts and holds the initial conference with the representatives of the contractor. Following this meeting the staff of the District Board analyzes the facts and prepares a full narrative report for the guidance of the negotiator and the Board. On the basis of this report,

further negotiations either by correspondence, personal call or Board meetings take place until an agreement is reached.

Quartermaster. The Quartermaster Corps Price Adjustment Section is now known as the Renegotiation Branch of the Procurement Division in the Office of the Quartermaster General. The Quartermaster General has delegated authority to conclude final renegotiation agreements with contractors whose total sales are not over $5,000,000.

Operations are decentralized with five field offices functioning under the administrative control of the Washington office. New York is the chief operating district office and exercises administrative control also over the other district offices at Boston, Chicago, San Francisco and Greenville, South Carolina. In addition to handling the renegotiation of contractors local to its area, the New York office controls the routing of cases to the other district offices and assists these offices in their renegotiation functions.

In its staff functions, the Washington office supervises the organization and personnel of the district offices and interprets for the Quartermaster Corps the principles, policies and procedures prescribed by the Renegotiation Division for the conduct of renegotiation. Washington also forwards cases received from the Assignment Branch of the Renegotiation Division to the New York office for renegotiation, reviews agreements concluded by the District offices before submission to the proper authority for approval, processes all cases and handles the renegotiation of impasse cases.

As of September 13, 1943, a total personnel of 187 were engaged in renegotiation in the Office of the Quartermaster General, 106 in the capacity of technical specialists and 81 as clerical assistants.

Cases received by the Washington Office are forwarded to the New York Section and, thence, if necessary, to a district office for renegotiation. A case is assigned to one or two negotiators for handling and the negotiator has the responsibility of supervising the renegotiation procedure, of conducting the conferences with the contractor and recommending the settlement. The negotiator is assisted by other staff members in financial analysis and report writing. All meetings are held at the district offices. In the event of a settlement in a district office, the case is returned to Washington for review and processing of the final agreement. If the field office is unable to conclude an agreement, the case is referred to a panel in Washington for further renegotiation.

Signal Corps. The Price Adjustment Section of the Signal Corps is established as a section of the Purchases Branch of the Procurement Division in the Office of the Chief Signal Officer. Headquarters are in Washington and two field Price Adjustment Sections in Philadelphia and Chicago function as subsidiary offices to Washington, all operating directly under the Chief Signal Officer. The Chief Signal Officer has redelegated authority to the Director of the Procurement Division to conclude agreements with contractors whose total contracts are not over $5,000,000.

The Cost Analysis Branch is under the Fiscal Division and serves both the Contracting Office and the Price Adjustment Section.

The Washington office supervises matters of policies, procedures and operations for all three offices, handles impasse cases for the Signal Corps and conducts negotiations itself on the West Coast. The field offices handle renegotiations assigned to them as coming within their jurisdiction. The chief negotiator and supervisor in Washington operate as an informal board, either or both of them sitting in with the negotiator on all cases assigned to the Washington office as well as on appeal cases from the field offices. The staff handling renegotiation in the Signal Corps includes negotiators, accountants, legal advisors, an engineer and clerical assistants. The clerical personnel of the Washington office handles all routine functions and correspondence as well as the distribution and processing details for all three offices.

As of September 13, 1943, the staff embraced a total of 42; of this number 22 were serving in a technical capacity.

Signal Corps procedure differs in certain respects from that of the other Services. Original contacts with a contractor must be conducted through one of the fifty Plant Agents, acting as liaison, operating in zones throughout the country. It is the Plant Agent's duty to make the initial contact, advise the contractor of the type of information, financial and otherwise, that will be required by the cost analyst and negotiator, arrange for obtaining directly or through the company's accountant the necessary financial information and arrange an initial meeting.

An attempt is made to obtain all necessary information prior to holding the first meeting with the representatives of the company. On assignment of the case to the Signal Corps, the Cost Analysis Branch, operating through the Plant Agent, obtains on a prepared form, as soon as possible, a summary of pertinent financial information. After the contractor has assembled the necessary information, a meeting is arranged at the Section office or representatives of the Cost Analysis Branch and Price Adjustment Section call at the contractor's office. Individual cases are assigned to specific negotiators whose responsibility it is to see that the cases are handled expeditiously and to carry through on a case until it is in form for the final renegotiation meeting, at which time an additional senior negotiator is present. The Price Adjustment Section and Cost Analysis Branch cooperate throughout and a cost analyst is present at all meetings with the contractor.

Surgeon General. The Renegotiation Division is established in the Supply Service, Office of the Surgeon General, with headquarters in Washington and field branches located in New York and Chicago. The Surgeon General has appointed, and delegated authority, for the conduct of renegotiation to the Director of the Division and has appointed a Review Board of five members, including the Director, to pass upon proposed agreements, prior to their submission for signature either to the Division Director or to the Surgeon General, or the War Department Price Adjustment Board. Recognizing the importance of close cooperation between renegotiation and procurement activities, close liaison in operations is maintained

between the Procurement Division, the Renegotiation Division, and the Commanding Officer of the Army Medical Purchasing Office.

The Director of the Division has appointed a Chief in the Washington Office and a Chief in charge of the New York and Chicago branch offices to supervise renegotiations under their jurisdiction, and, in turn, they have, with the approval of the Director, organized the necessary staffs, including negotiators and cost analysts, to carry out their functions. The negotiator has complete responsibility for the prompt and final disposition of all cases assigned to him. In carrying out this assignment, he arranges for an initial conference with the contractor, attended jointly by himself and the cost analyst; gathers with the assistance of the cost analyst all essential information from any source available; conducts further renegotiation meetings; is responsible for minutes of procedure; prepares standard reports with the cooperation of the cost analyst, and final agreements, and expedites processing of each case through the Review Board to the end that the final agreement is forwarded to the contractor as soon as possible. The cost analyst is charged with the procurement, analysis and reporting on proper forms and reports of all necessary accounting information. The chief of the Renegotiation Branch advises the negotiator, and the Chief of the Cost Analysis Branch of the Washington office counsels with the cost analyst on all matters of procedure.

The total personnel, as of September 13, 1943, engaged in renegotiation work in the Surgeon General's Office was 32, including 22 technical representatives and 10 clerical assistants.

All dealings with the War Department Price Adjustment Board are handled directly with the Washington office of the Renegotiation Division, and all assignments from the Board go directly to the Washington office. The Washington office sends out the initial letter requesting data and continues as contact with the contractor until it is possible to determine the nature of the case and whether it is appropriate to hold the preliminary meeting with the company. Where called for, cases are assigned by Washington to the New York or Chicago Branch and the Chief of each field branch, guided by instructions from the Director of the Division, assigns the case to a team of two, consisting of representatives of the Renegotiation and Cost Analysis Sections. At this time, the company is notified of the transfer and directed to correspond with the appropriate field branch. Certain cases are retained for renegotiation by the Washington office.

Subject to the supervision of the Chief of the field branch, the negotiator to whom the case is assigned has complete discretion in handling the case and in calling the preliminary conference. Immediately following the meeting the minutes of the proceedings are drawn up and sent directly to the Washington office. The negotiation team then prepares a tentative report of renegotiation and obtains approval of the Chief of the branch and of at least two members of the Review Board as to any proposed basis of settlement prior to the final conference with the company. Where an agreement is reached, the negotiator and cost analyst com-

plete their report on all aspects of the case and submit it to the Washington office together with copies of the final agreement.

No agreement is sent to the contractor for execution until it has been approved by a member of the Review Board. Where the agreement involves any substantial departure from the form prescribed by the War Department Price Adjustment Board, and/or where it involves any new and unusual provisions, it is submitted to at least two other members of the Review Board before it is sent to the contractor for execution. To assist the field office, representatives from Washington regularly visit the field offices. All processing and distribution of the final reports and agreements are performed by the Washington office.

The Surgeon General has redelegated to the Renegotiation Division Director power to enter into final and other agreements with contractors whose total sales do not exceed $5,000,000. The Review Board has been granted the authority to pass on all agreements, and unanimous approval by the Board is required before submission to the Director or Surgeon General for signature. Cases in which the final agreement is not unanimously approved by the Board are either referred back to the Division for further negotiations or to the War Department Price Adjustment Board for final action.

Transportation. Renegotiation in the Transportation Corps is conducted from a central office in Washington. Control of this function has been delegated to the Chief of the Fiscal Division. Flexible in operation, two key men function informally as final authority on matters of review, instead of a formal board, and the Chief of the Fiscal Division has the power to sign agreements recommended by this panel.

To accomplish decentralized operation and accommodate the convenience of the contractor, the Transportation Price Adjustment Section has located in each of the nine transportation zones one or two junior officers, trained in renegotiation procedure, able to undertake the necessary accounting work with a contractor and to assist in the determination of the amounts of business properly subject to renegotiation and the breakdown of costs applicable to renegotiable business. Assisting these representatives, the Washington office uses teams of negotiators in cities adjacent to the offices of the contractors where it is impractical for these contractors to come to Washington. The customary procedure in preparing the necessary case histories and financial analysis of renegotiable business is followed.

As of September 13, 1943, the personnel of this Section totaled 28, including 2 men in charge of operations, 2 other negotiators, 4 cost analysts operating within the office and 16 other accountants located in the Procurement Districts throughout the country devoting part time to renegotiation.

Navy Department Price Adjustment Board

The Under Secretary of the Navy has established a Price Adjustment Board with Divisions at New York and Washington and Regional Price Adjustment

Boards at Chicago and San Francisco to conduct the renegotiations of contracts pursuant to the Act. These Boards have been created in the Office of Procurement and Material under the supervision of the Assistant Chief in Charge of Procurement.

The Navy Department Price Adjustment Board in Washington determines all questions of policy and procedure, with the approval of the Under Secretary of the Navy and conducts actual renegotiation with contractors. The New York office and the Regional Boards conduct the renegotiation proceedings of contractors in their regions. The main office of the Board in Washington has seven Board members, including the Chairman and Executive Vice Chairman, while six other Board members, operating under a Vice Chairman, are located in New York City. Operating under regional Chairmen, the Chicago Board has five members and the San Francisco Board has four members.

Following the policy of employing only the most highly trained personnel with practical experience in the phase of work for which they are engaged, all Board members are experienced professional and business men, practically all of the accountants are Certified Public Accountants and the analysts are experienced in financial work. As of August 31, 1943, the personnel of all four Boards totaled 181, including 22 Board members, 23 other contract employees, 72 officers and 64 Civil Service employees. In addition, the Navy utilizes some 150 panel auditors—partners or senior employees of leading accounting firms throughout the United States who have agreed to lend their services on a per diem basis, when required, to assist the contractors in preparing factual material needed by the Board.

The Navy has made every effort to simplify the procedures of renegotiation so as not to place any undue burden on contractors. Names of all contractors and subcontractors engaged in war work are obtained through the joint Assignment Section of the Departmental Price Adjustment Boards from various governmental agencies or other sources of information including the income tax returns of corporations. Where there is a possibility of the existence of excessive profits requiring renegotiation, the "Preliminary Letter of Information" is sent to the contractor requesting current data, including balance sheets and profit and loss accounts, a breakdown between renegotiable and non-renegotiable business and the total business done with each governmental Department and Agency. Upon the basis of this information, a case in which the Navy Department has the predominant interest is assigned to the Navy Department Price Adjustment Board.

Accountants and analysts of the Board study these data and supplement them with other sources of information and by contacting the procurement officers of the governmental Departments and Agencies doing business with the contractor. A preliminary report is then prepared for consideration by the Board and, if it is apparent that no excessive profits exist, the Board immediately gives the contractor a clearance, notifying the company accordingly by letter.

If, on the other hand, there may be excessive profits, several procedures may be followed. The case may be referred to a panel auditor or to one of the Board's own accountants who calls upon the contractor and assists him in preparing further factual information desired by the Board.

If the amount involved is relatively small, the case may be handled through so-called field renegotiation whereby the Board assigns the case to one of its own accountants and analysts to call on the contractor, develop the necessary additional information and endeavor to arrive at a mutually satisfactory agreement regarding any excessive profits. If an agreement is reached in the field, it is submitted to the Washington Board for consideration and approval, and the contractor is further advised of his right, if he prefers to do so, of appearing before one of the Boards.

In a number of cases, however, the contractor appears before the Board. The analyst and an accountant prepare a complete report and the contractor is encouraged to develop whatever further facts he may wish the Board to take into consideration. At the Board meeting, attended by the company's representatives and by the Board members, the analyst and accountant as well as contracting officers and representatives from the technical bureaus familiar with the material produced and with the company's performance, a full discussion of all phases of the company's war work, earnings and costs is held. If an agreement is reached as to the proper settlement, a contract is prepared and submitted for approval to the Under Secretary of the Navy who is also sent a summary of the facts of the case. If no agreement can be reached the facts are submitted to the Under Secretary of Navy for such action as he may take.

Maritime Commission

The Price Adjustment Board of the Maritime Commission was created by action of the Commission embraced in Administrative Order No. 64 and to this Board the Chairman of the Maritime Commission delegated the powers and duties conferred upon him under the Act.

The Board located in Washington is comprised of four members, a member of the Maritime Commission serving as Chairman, a Naval officer who is in active charge of all of its operations, the counsel of the Board and the representative of the War Production Board.

As of October 1, 1943, there was a total personnel of 40, including the Board members, 13 renegotiators, 15 accountants and 9 stenographers.

Cases assigned to the Maritime Commission Price Adjustment Board are in turn assigned to individual renegotiators who have charge of the preparation of the individual company cases. The renegotiator is assisted in the actual renegotiation by an additional renegotiator so that at all times there are at least two renegotiators, together with a member of the analyst section, acting at the renegotiation conference with the company.

In the preparation of a case the Board relies to a large extent on certified audits furnished by the contractor. As contrasted with the procedure of the War and Navy Departments, the Board does not have any established field auditing system and does not utilize a field auditor except in an exceptional case when Maritime Commission field auditors are employed.

After conferences with the contractor have been held, the renegotiators present the facts to the Board, which arrives at a decision as to the amount of excess profits, if any. Contracts or clearance letters are then drawn and are approved by the Commission and signed by the Chairman.

War Shipping Administration

Executive Order 9054, dated February 7, 1942, created the War Shipping Administration, delegating to it certain of the functions previously exercised by the Maritime Commission. Following the passage of the Renegotiation Act, the Order was amended on September 16, 1942, by Executive Order 9244 to specifically delegate appropriate powers of renegotiation, conferred upon the Maritime Commission under the statute, to the War Shipping Administration. In conformance with this authority the War Shipping Administrator on February 12, 1943, created the Price Adjustment Board within the War Shipping Administration and charged the Board with the responsibility of renegotiation.

The Administrator has appointed a Board of five members and a Chairman of the Board to supervise renegotiation procedure. The Board is composed of the Chairman, the General Counsel of the War Shipping Administration, the War Production Board representative and two other members. The office of the Board has been established in New York City as this location is in closest proximity to the great majority of War Shipping contractors and furnishes the best market for the specialized personnel required for this work.

In contrast to the other agencies engaged in renegotiation, the War Shipping Board is engaged primarily in the renegotiation of contracts for the rendition of services. As the result of the special problems involved in repairing, chartering, stevedoring and operating of vessels, specialized experience and background is required, and much of the time of this Board to date has been devoted to securing the necessary capable personnel versed in the marine industry. At present this Board has assembled a small but well-qualified staff, which is assisted by members of the Auditing Department of the Administration who are located in New York City and in the various yards.

General operations in the conduct of renegotiation follow the pattern of the *War Department Manual for Renegotiation*. Assignments are received through the Joint Departmental Assignment Board, the necessary information is obtained, and renegotiations are conducted to the end either of a clearance or a mutual agreement as to the amount of excessive profits which have been or may be realized. A comprehensive survey of the stevedore trade was completed to determine the profits existing in various areas before renegotiation of a single stevedore was attempted.

The War Shipping Administration makes considerable use of a contractual recapture clause wherein a contractor agrees to refund all profits in excess of 10 per cent. As a consequence, it is necessary for their auditors to make an audit of War Shipping contracts so that the monies due under this clause may be recaptured prior to commencement of renegotiation procedure. For this reason and because the contractors in this field, dealing largely with labor, are even more deluged than manufacturers with demands for figures and reports, the conduct of renegotiation has been considerably delayed.

Treasury Department

Authority for renegotiation in the Treasury Department was redelegated by the Secretary of Treasury to the Director of Procurement. The Director was empowered to act for the Secretary in the establishment of the necessary organization and in approving renegotiation agreements. Accordingly the Director of Procurement established the Treasury Department Price Adjustment Board, appointed the Chairman and the other members of the Board, and authorized the Chairman to select the operating staff.

The Board is comprised of the Chairman, the representative of the War Production Board and three other members, in addition to legal counsel who attends in an advisory capacity. There is also an operating staff of 11 analysts, the majority being either Certified Public Accountants or chartered accountants, and a clerical force of 12. At this date the Board functions only in Washington, no renegotiations having been conducted in the field.

The procedures for renegotiation in the Treasury Department have been patterned after those of the War Department. Following assignment, an analyst gathers the necessary information and prepares the preliminary report for review by the Board prior to conferences between the Board and the contractor. The final report, upon approval by the Board, is prepared by a Board member for the signature of the Director of Procurement.

Reconstruction Finance Corporation

The four subsidiaries of the Reconstruction Finance Corporation handling war purchases—namely, Defense Plant Corporation, Metals Reserve Company, Defense Supplies Corporation and Rubber Reserve Company—were brought within the purview of the Act by amendment dated July 1, 1943. The Boards of Directors of these companies delegated all their authority under the Act to one central Board in Washington. Comprised of five members, including an appointed chairman and the heads of each of these companies, the Reconstruction Finance Corporation Price Adjustment Board handles renegotiation for all these agencies.

The Board alone has the power of final determination. A Reviewing Committee of three members has been created by the Board to conduct the actual work of renegotiation. While this Committee does not as yet have the power of final determination, it carries the full authority of the Board in other matters. A staff

of negotiators, cost analysts and legal personnel is being formed to handle the usual detailed functions and to confer with contractors.

In forming its organization, the Board called in representatives from 11 of the Reconstruction Finance Corporation field offices for training in the principles, policies and procedures of renegotiation. It is proposed that these men will train additional representatives on returning to their districts. It is estimated that the personnel requirement of the Board will reach a total of 100 by next July, including 40 negotiators, 30 cost analysts and 30 clerical employees.

Owing to its long experience and established procedures, the Reconstruction Finance Corporation Board anticipates the ability to handle renegotiation on a practical and flexible basis with its negotiators located throughout the country for the convenience of the contractors. On new cases, these representatives will obtain information in the field, eliminating the need for calling the contractor to Washington. On closed cases, wherein Reconstruction Finance Corporation contracts are similar to the business already renegotiated, the negotiator will be granted limited authority to reach a further settlement on the same basis. Where cases have already been assigned and are not completed, this Board will allow the Department or Service having the assignment to complete the cases with respect also to Reconstruction Finance Corporation business.

CONCLUSION

The task of renegotiation has been difficult. With the passage of the statute, a staggering volume of war contracts became subject to renegotiation and the problem was further complicated by the pressure of time. The Act prescribes that renegotiation proceedings must commence within one year following the close of the fiscal year of the contractor within which completion or termination of a contract occurs. The entire administrative machinery and procedures for renegotiation have been developed since April 28, 1942, with the view to performing this work as expeditiously as possible, with maximum fairness to both the Government and war contractors, and to completing the renegotiation of war contracts within the statutory time allowed.

In the short space of one year and a half, the pioneering work of organization, of formulation of principles, policies and procedures and of renegotiation of a substantial volume of war contracts has been completed. As the result of able administration and the splendid cooperation of American industry, the work has progressed satisfactorily in the face of innumerable problems and of the expressed opinion in certain quarters that renegotiation would take one hundred years and was impossible.

The assignment of 1942 business for renegotiation has been practically completed. After reviewing the large majority of possible renegotiation cases and withholding from assignment many thousands of companies as not being subject

to renegotiation on their 1942 business, the Clearance and Assignment Officer, as of October 1, 1943, had assigned 20,457 cases for renegotiation.[9]

With each Department and Service gearing its organization and machinery to effect substantial completion of the renegotiation of 1942 business by the end of 1943, the work of actual renegotiation is now in full swing. While there are variations in the rate of production between the various agencies, progress throughout the field of renegotiation has been satisfactory. As of October 1, 1943, agreements have been reached in over 40 per cent of the total number of cases assigned, these cases representing by far the bulk of 1942 renegotiable business by dollar volume.

The total original dollar amount of the contracts already renegotiated is approximately $38,000,000,000, and, on these contracts, commitments for the elimination of excessive profits in the amount of approximately $4,500,000,000, have been made as of October 1, 1943. (It is estimated that of this amount only 70-75 per cent would have eventually accrued to the Government through taxes.) Cash refunds represented around $2,200,000,000 and price reductions around $2,300,000,000 of this amount.

With the machinery for renegotiation now well established, with personnel selected, indoctrinated and experienced, and with major principles, policies and procedures determined, the price adjustment work is expected to accelerate substantially. From the standpoint of both the Government and industry, renegotiation can henceforth be expected to be completed more expeditiously than during the pioneering days now well behind us.

APPENDIX

Addresses of Offices.

Price adjustment offices for the various departments, agencies and sections handling renegotiation work are located at the following addresses:

Departmental Price Adjustment Boards: War Department, Room 3D 581, The

[9] While not indicative of the dollar volume or amount of work involved, the following table of these assignments reflects to a degree the relative task of the renegotiation agencies:

Departments	*Assignments as of October 1, 1943*	
War Department		
Price Adjustment Board	608	
Army Air Forces	2,397	
Chemical Warfare	169	
Engineers	4,139	
Ordnance	3,484	
Quartermaster	3,372	
Signal Corps	504	
Surgeon General	366	
Transportation	130	
Total War Department		15,169
Navy Department		4,074
Maritime Commission		686
War Shipping Administration		286
Treasury Department		135
Reconstruction Finance Corporation		107
		20,457

Pentagon, Washington, D. C.; Navy Department, 718 18th Street, N. W., Washington, D. C., 630 5th Avenue, Room 310, New York, N. Y., 21st Floor, 100 West Monroe St., Chicago, Ill., 727 Financial Center Building, 405 Montgomery St., San Francisco, California; Maritime Commission, Room 4827, Commerce Building, Washington, D. C.; Treasury, Room 5304, Procurement Building, 7th & D Streets, S. W., Washington, D. C.; War Shipping Administration, 39 Broadway, New York, N. Y.; Reconstruction Finance Corporation, 811 Vermont Avenue, N. W., Washington, D. C.

Price Adjustment Sections, War Department: Ordnance, Room 4E 371, The Pentagon, Washington, D. C.; 700 Frank Nelson Building, Birmingham, Alabama; Room 1501, 140 Federal Street, Boston, Mass.; 38 South Dearborn Street, Chicago, Illinois; Big Four Building, Cincinnati, Ohio; 1006 Terminal Tower Building, Cleveland, Ohio; 1832 National Bank Building, Detroit, Michigan; Room 1815, 80 Broadway, New York, N. Y.; 150 South Broad Street, Philadelphia, Pa.; 1202 Chamber of Commerce Building, Pittsburgh, Pa.; 1238 Mercantile Building, Rochester, N. Y.; 3663 Lindell Boulevard, St. Louis, Missouri; 402 Hotel Empire, San Francisco, California; 95 State Street, Springfield, Mass.

Quartermaster Corps: Room 2049 Tempo B, 2nd & Q Streets, S. W., Washington, D. C.; 521 5th Avenue, New York, N. Y.; 1 State Street, Boston, Mass.; 333 North Michigan Avenue, Chicago, Illinois; Kohl Building, Montgomery & California Streets, San Francisco, California; Woodside Building, Greenville, South Carolina.

Signal Corps: Room 2C 285, The Pentagon, Washington, D. C.; 1 North LaSalle Street, Chicago, Illinois; 17th & Sansom Streets, Architects Building, Philadelphia, Pa.

Army Air Forces: Room 5E 1039, The Pentagon, Washington, D. C.; Wright Field, Dayton, Ohio; 67 Broad Street, New York, N. Y.; 420 West Douglas Avenue, Wichita, Kansas; 3636 Beverly Boulevard, Los Angeles, California; Fox Theater Building, 7th Floor, Detroit, Michigan; Room 636 Enquirer Building, 617 Vine Street, Cincinnati, Ohio; 20 North Wacker Drive, Chicago, Illinois; Room 204, 4900 Euclid Building, Cleveland, Ohio.

Corps of Engineers: Room 5160, New War Building, 21st & Virginia Avenue, N. W., Washington, D. C.; 605 Lincoln Road, Miami Beach, Florida; 75 Federal Street Building, Boston, Mass.; 270 Broadway, New York, N. Y.; 101 E. Fayette Street, Baltimore, Maryland; 50 Whitehall Street, Atlanta, Georgia; 1120 Huntington Bank Building, Columbus, Ohio; 332 South Michigan Avenue, Chicago, Illinois; 1114 Commerce Street, Dallas, Texas; 206 South 19th Street, Omaha, Nebraska; 351 California Street, San Francisco, California.

Surgeon General: Room 419 Maritime Building, 1818 H Street, N. W., Washington, D. C.; 52 Broadway, New York, N. Y.; 12th & Spruce Streets, St. Louis, Missouri.

Transportation Corps: Room 3A 674, The Pentagon, Washington, D. C.

Chemical Warfare Service: Butler Building, 200 West Baltimore Street, Baltimore, Maryland.

RENEGOTIATION AND FEDERAL TAXATION

WADSWORTH WATTS*

I

The solution of the problems arising in coordinating renegotiation with the Internal Revenue Code has been accomplished through a process of development. As originally enacted, the renegotiation statute[1] which became effective April 28, 1942, did not state expressly the effect of the elimination of excessive profits upon income for the taxable year affected. The Statute, however, provided that, although the purpose of renegotiation was to eliminate excessive profits, nevertheless, this purpose was to be achieved through revision of price by renegotiation.[2] At the outset, the situation was clear where excessive profits were eliminated through price reductions upon future deliveries or future performance. It also seemed clear that even though excessive profits were eliminated by retroactive price reductions resulting in a refund, if the obligation to make the refund was fixed or if the refund was paid within the taxable year in which the delivery or performance took place, then income for that taxable year was reduced.[3]

If, however, the renegotiation took place after the fiscal year of the contractor in which delivery or performance took place and for which year the Federal income and excess profits tax returns had been filed, questions arose concerning the taxable year in which the adjustment should be reflected. It was puzzling, too, whether the answer to this question would vary, depending upon a number of circumstances. Some of those circumstances were whether the contract had been entered into prior to the effective date of the Act, whether the deliveries with respect to which the prices were retroactively reduced had been made prior to that date, and whether the contract contained a renegotiation clause inserted pursuant to the directions contained in subsection (b) of the Renegotiation Statute. If it were determined that the retroactive price adjustment affected income for a prior fiscal year, for which a Federal tax return had been filed, must the contractor make his renegotiation refund in full through the renegotiation agency and file a claim for a refund with the Bureau of Internal Revenue, or should the Federal taxes paid with respect

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[1] 56 STAT. 245, 41 U. S. C. A. note prec. §1 (Supp. 1942) (Section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942, as amended).

[2] *Id.* at §403(c).

[3] Through this article, discussion is confined to taxpayers on an accrual basis.

to the excessive profits eliminated be deemed as a partial refund of the excessive profits?

Early in the administration of the Renegotiation Statute, the Bureau of Internal Revenue in a statement of policy, contained in *I. T. 3577* (Internal Revenue Bulletin 1942, No. 37),[4] gave its answer to these and other problems. The Bureau took the position that in case the renegotiation agreement provided a reduced contract price to be retroactively applied to a prior taxable year for which a tax return had been filed, and for which the income and excess profits taxes had been paid or assessed, then only the amount of the resulting refund of excessive profits which exceeded the Federal taxes assessed thereon should as a result of renegotiation be paid by the contractor. The amount of the taxes paid should be credited against the excessive profits eliminated and no refund or abatement of the taxes paid or assessed for the prior taxable year would be made. The Bureau stated, however, that in the case of a renegotiation agreement affecting a year for which income and excess profits tax returns had not been filed, the returns for that year should, when filed, reflect the results of renegotiation.

In its earliest detailed public release on policies and procedures to be followed in renegotiation, the War Department Price Adjustment Board coordinated its administration of the Act with the statement of policy expressed by the Bureau of Internal Revenue in *I. T. 3577*. In paragraph 4 of subdivision VIII of *Principles, Policies and Procedures to be Followed in Renegotiation* issued by the War Department Price Adjustment Board, dated August 10, 1942, it was stated that in renegotiation for a prior fiscal year where the return of excessive profits ordinarily takes the form of a refund, that part of the taxes previously assessed representing taxes on the excessive profits agreed upon should be taken into consideration in the renegotiation.

The Revenue Act of 1942,[5] effective October 21, 1942, added Section 3806 to the Internal Revenue Code. This Section, in general, carried into statutory enactment the policies adopted by the Bureau of Internal Revenue and the War Department Price Adjustment Board with respect to the treatment of Federal income and excess profits taxes in renegotiation. The advantages of clarification by legislation of the questions involved, rather than by administrative interpretation, are obvious.

II

In conformity with well-established precedents relating to the drafting of tax legislation, the phraseology of Section 3806 is disturbingly complex. The broad aspects of the Section, however, seem clear enough. Subsection (a) provides that if, pursuant to renegotiation, excessive profits received or accrued under a contract for a prior taxable year are eliminated, and the taxpayer is required to repay such excessive profits, then the part of the contract price received or accrued for the prior taxable year is to be reduced by the amount of the repayment. Subsection (a) further provides that such repayment will not constitute a deduction for the year

[4] 1942—2 CUM. BULL. 163.
[5] 56 STAT. 798, 26 U. S. C. A. §3806 (Supp. 1942).

in which it is paid or in which the obligation to pay it is incurred. Subsection (b), in general, states that there shall be credited against the repayment of excessive profits in such a situation the amount by which the tax for the prior taxable year would have been reduced if the excessive profits eliminated had never been a part of income. No interest, however, is to be allowed with respect to any credit to which the contractor is entitled under the Section. In subsection (c) it is stated that the credit provided under Section 3806 is to be in lieu of any other credit or refund resulting from the adjustment to income for the prior fiscal year provided for in subsection (a). And, finally, subsection (c) provides that if for any reason the credit allowable under Section 3806 exceeds that actually allowed by the renegotiation agencies against the excessive profits eliminated, then such excess is to be treated as an overpayment of tax for the prior taxable year.

While Section 3806 of the Internal Revenue Code clarified the most important questions involved in the correlation of taxes and renegotiation, nevertheless, in its application to renegotiation, some questions have arisen.

Effect of Retroactive Price Reductions on Post-war Refund of Excess Profits Tax. By Section 780 of the Internal Revenue Code, the Secretary of the Treasury is directed to establish a credit for the account of each taxpayer subject to the excess profits tax, of an amount equal to 10% of the excess profits tax for each taxable year ending after December 31, 1941. This credit is to be realized by the taxpayer after the war. When a credit is granted under Section 3806 of the Internal Revenue Code, is this post-war refund credit reduced? A strange situation would result were it not reduced. The corporation which currently priced its war products at figures yielding only reasonable profits would, of course, pay no excess profits tax on any excessive profits since none ever accrued in its income. But the corporation which priced its products to yield excessive profits, resisted all efforts on the part of procurement officials to price reasonably and delayed renegotiation until after filing its tax returns, would receive a bonus equal to 10% of the excess profits tax paid upon its excessive profits. And the higher the price the larger in dollars would be this bonus. Fortunately, it seems quite clear that such a situation does not exist. While the credit under Section 3806 is granted and allowed by the renegotiation agencies, not the Bureau of Internal Revenue, nevertheless, it is a credit granted pursuant to the Internal Revenue Code, since Section 3806 is a part of that code. Section 781(b) of the Code provides that if any overpayment of the tax imposed by Chapter 2E, the chapter imposing the excess profits tax, is refunded or credited to the taxpayer under the internal revenue laws, the post-war credit shall be reduced accordingly. The Section 3806 credit is clearly a credit under the internal revenue laws. Also, it would seem to be a credit of an overpayment of the excess profits tax. The basic theory of Section 3806 is that the taxpayer overpaid its tax through being taxed on profits which in effect it was not entitled to retain and must refund. The simple way of adjusting for the overpayment is the method provided in the section. The result to the taxpayer and to the United States is exactly the same in dollars, as though the taxpayer had refunded its excessive profits in full without tax

credit, had amended its return for the year affected by the retroactive price reduction, and had claimed a refund resulting from an overpayment of the tax for that year.

That the post-war refund is adjusted to reflect a credit granted by a renegotiation agency is pointed out by the Bureau of Internal Revenue in *I. T. 3611*.[6] In that interpretation of Section 3806 the Bureau states:

"In view of the provisions of Section 3806, it is the opinion of this office that the taxpayer's net income for Federal income and excess profits tax purposes is required to be in effect, determined upon the basis of, and by giving effect to the renegotiation * * * Also the amount of the post-war refund under Sections 780 and 781 of the Code of excess profits tax shall be reduced to reflect the amount of such tax which is credited against the excessive profits eliminated."

Effect of a tax credit under Section 3806 upon income for tax purposes for the prior year. *A* has net income for tax purposes in 1943 of $2,000,000. After he has filed his 1943 return he is renegotiated for that year and agrees to refund $750,000. His Section 3806 tax credit is computed and appears to be $600,000 based upon the return as filed, and he pays through the renegotiation agency $150,000, the net amount remaining after the application of the credit. When, however, the Bureau of Internal Revenue audits *A's* return, it finds that his net income for tax purposes was $500,000 in excess of that shown by the return. Will the Bureau compute the deficiency upon the basis of an income of $1,750,000, the income shown by the return as filed but adjusted for renegotiation plus the additional $500,000, or upon an income of $2,500,000, the income shown by the return as filed but unadjusted for renegotiation and plus the additional $500,000? This, of course, is important to an individual in view of the graduated nature of the Federal tax.

It is clear from the provisions of Section 3806(a)(1) that, although the tax return for the prior year has been filed and the tax assessed, a retroactive price reduction for the prior year effected through renegotiation reduces income for that prior year. Therefore, in *A's* case the deficiency in tax must be computed upon an income of $1,750,000, the income adjusted for the renegotiation refund and plus the additional $500,000. Nor is it necessary to amend the tax return for the prior year to effect this result. Section 3806 indicates that the adjustment to income is automatic, and the Bureau of Internal Revenue is requiring no amended return in order to effect the adjustment. In *I. T. 3611*[7] the Bureau states:

"In view of the provisions of Section 3806 it is the opinion of this office that the taxpayer's net income for Federal income and excess profits tax purposes *is required* to be in effect determined upon the basis of, and by giving effect to, the renegotiation." (Emphasis supplied.)

Effect of the Granting of a Section 3806 Tax Credit Upon Subsequent Tax Refunds. Corporation *B* had a net income for Federal tax purposes for 1942 amounting to $3,000,000. It has filed its Federal tax returns for that year and a tax of $2,400,000 has been paid or assessed with respect to 1942 income. It is re-

[6] 1943 INT. REV. BULL. No. 12, at 7, 8. [7] *Ibid.*

negotiated for 1942 after its returns have been filed and agrees to refund $2,000,000 as excessive profits. The Section 3806 tax credit relating to this refund is $1,600,000 resulting in a net cash refund through the renegotiating agency of $400,000. In a fiscal year ending after the termination of the war it loses $1,500,000 which pursuant to the provisions of the Internal Revenue Code may be carried back to the year 1942, resulting in an adjustment of the income and excess profits tax for the year 1942 and a tax refund resulting from this adjustment. Is the tax available for refund the $2,400,000 shown upon the returns as filed, or is it this amount reduced by the credit allowed pursuant to the provisions of Section 3806? A similar problem would arise had Corporation *B* been entitled to an adjustment of the income and excessive profits tax for 1942 through accelerated amortization of emergency facilities with respect to which certificates of necessity had been issued. The tax available for refund is not the $2,400,000 shown upon the returns filed, but is the amount reduced by the $1,600,000 used as a credit against the 1942 excessive profits eliminated. While the only specific provision of Section 3806 of the Code relating to other credits or refunds is that contained in subsection (c) of that section which provides against other credits or refunds under the internal revenue laws founded on the application of subsection (a) of Section 3806; nevertheless, in view of the fact that Section 3806(a) specifically provides that a retroactive price reduction reduces income for the prior year, it would seem to follow necessarily that the tax for the prior year is reduced to the extent of a tax credit granted. The Bureau of Internal Revenue in *I. T. 3611*[8] states its position that "no refund of tax for any taxable year shall include any amount of tax which, pursuant to Section 3806(b) is credited against excessive profits eliminated for such year." An example is given in *I. T. 3611*[9] of a corporation receiving a $700,000 tax credit under Section 3806 and the Bureau states with respect to this $700,000 that "no part of the $700,000 Federal income and excessive profits taxes shall be refunded or credited to the taxpayer under Sections 321 and 322 of the Code. However, for the purpose of determining the correct tax for 1942 the amount of tax shown by A Corporation on its return for such year shall be decreased by the $700,000 credit allowed against excessive profits."

Declared Value Excess Profits Tax. It will be observed that Section 3806(b) of the Internal Revenue Code provides for credit against excessive profits eliminated of the amount by which the tax for the prior taxable year under Chapter 1, Chapter 2A, Chapter 2D and Chapter 2E of the Internal Revenue Code is decreased by reason of eliminating from income the excessive profits agreed to be refunded. Chapters 1, 2A and 2D relate to income taxes. Chapter 2E relates to the excess profits tax. Chapter 2B relating to the declared value excess profits tax is conspicuous by its absence. Nevertheless, it will be seen from an example set forth in *I. T. 3611*[10] that in computing Section 3806 tax credits, the computation includes a credit to the extent by which the declared value excess profits tax for the prior year is reduced through the adjustment to income resulting from renegotiation. Al-

[8] *Ibid.* [9] *Id.* at 9. [10] *Ibid.*

though Chapter 2B is not specifically mentioned in Section 3806(b), it must be remembered that Section 3806(a) requires an adjustment of income for the prior year to reflect a retroactive price reduction effected through renegotiation. Were Chapter 2B not considered in computing the Section 3806 credit, it would seem that the Bureau would be required to adjust the declared value excess profits tax through some sort of an amendment to the return for the prior year. Since the purpose of Section 3806 seems to have been to effect all necessary adjustments in the tax resulting from required adjustments to income caused by retroactive price reductions, the reasonable interpretation of the Section seems to be that the declared value excess profits tax adjustment should be made through the Section 3806 credit. At any rate it is the position of the Bureau of Internal Revenue that a Chapter 2B adjustment should be allowed and it is included in their computations in the amount of the credit. (See *I. T. 3611* cited above.)[10a]

Necessity of Coordination between Renegotiating Agencies and the Bureau of Internal Revenue. As pointed out above, while Section 3806 is a part of the Internal Revenue Code, nevertheless, the credit based upon that section is actually allowed by the renegotiation agencies. In practice, the Internal Revenue Agent in Charge of the district in which the contractor has filed his tax return is asked to compute the amount of credit to which the contractor is entitled, based upon his tax return as filed. The original of this computation is sent to the renegotiation agency with a copy to the contractor. The mere fact that an Internal Revenue Agent in Charge has been asked to make a computation is not a sufficient basis for the Bureau of Internal Revenue to make the required adjustments to income. The computation of credit may be asked in contemplation of an agreement to be made in the future and for some reason or other the transaction may not be carried through, in which event no credit would be allowed. Therefore, when a renegotiation agreement is signed and an allowance of a tax credit against excessive profits eliminated is actually made by a renegotiation agency, the Bureau of Internal Revenue is notified. The Bureau then has in the taxpayer's file sufficient information to effect the necessary adjustments, no matter what they may be, or when they may arise.

Effect of Section 3806 on I. T. 3577.[11] It will be recalled that *I. T. 3577* mentioned above was issued by the Bureau of Internal Revenue prior to the enactment of Section 3806 of the Code. While Section 3806 codifies that portion of *I. T. 3577* relating to renegotiation for a prior fiscal year following the filing of the tax returns for that year, nevertheless, it is not explicit as to the effect of the elimination of excessive profits by retroactive price reductions effected before the tax returns have been filed. Upon the enactment of Section 3806 of the Code, question was raised as to whether in view of this situation *I. T. 3577* still expressed the policy of the Bureau with respect to retroactive price reductions made by refunds or agreements to re-

[10a] Section 701(c)(2) of the Senate Finance Committee's version of the Revenue Bill of 1943 (H. R. 3687, 78th Cong., 1st Sess., 1943) includes an amendment to Section 3806(b)(1) and (b)(2) of the Internal Revenue Code which would make these subsections explicit in directing that the declared value excess profits tax be considered in determining tax credits under Section 3806.

[11] *Supra* note 4.

fund prior to the filing of the tax return for the year affected. These questions have been answered by *I. T. 3611*[12] which reaffirms the statement of policy continued in *I. T. 3577* relating to retroactive price reductions effected before the returns for the year affected have been filed.

It should be pointed out that one qualification exists to the general proposition that if a taxpayer agrees to repay excessive profits prior to the filing of a Federal tax return for the year affected, the excessive profits agreed to be repaid should be and are eliminated from income in the returns filed for that year. If at the time the Bureau audits the taxpayer's return for the year affected, the taxpayer is in default in any payments required to be made under his renegotiation agreement and which have been eliminated from income in preparing the return, the Bureau will add these defaulted payments to income for the year, and collect the tax with respect thereto. For example, Corporation *A* having income of $2,500,000 for the year 1942, is renegotiated before its returns for that year are filed, and agrees to repay $1,000,000 in excessive profits. This it agrees to pay in four equal installments, one on March 15, 1943, another on June 15, 1943, still another on September 15, 1943, and the last on December 31, 1943. In accordance with *I. T. 3577* the entire $1,000,000 is then eliminated from income in filing its returns on March 15, 1943. The Bureau then audits its returns early in 1944 and finds the corporation has not paid the last two installments aggregating $500,000. The Bureau will add these defaulted installments to 1942 income and assess a deficiency tax with respect thereto.

The taxpayer will immediately be concerned whether, after this deficiency has been assessed, he will then be liable for these two installments in full under his renegotiation agreement. The standard form of agreement now in use by the renegotiation agencies, contains substantially the following clause, although the renegotiation relates to a year for which tax returns have not been filed:

"Should for any reason the profits eliminated hereby be includable in gross income of the contractor for the purposes of determining taxes payable for said fiscal year under Chapters 1, 2A, 2B, 2D and 2E of the Internal Revenue Code the contractor shall be allowed the credit, if any, to which he is entitled under Section 3806 of the Internal Revenue Code with respect to the profits eliminated hereby."

It is intended by this clause to make it clear that if for any reason such taxes are assessed by the Bureau upon any of the profits eliminated, the contractor will be entitled to the appropriate credit in refunding such profits through a renegotiating agency.

III

When the Current Tax Payment Act of 1943[13] became effective, question immediately arose as to its effect upon Section 3806 of the Internal Revenue Code. The Current Tax Payment Act of 1943 provides that the income tax of each individual for the taxable year 1942 is forgiven as of September 1, 1943. While the tax for the

[12] *Supra* note 6.

[13] Pub. L. No. 68, 78th Cong., 1st Sess. (June 9, 1943); 57 STAT. —.

taxable year 1943 under this act is based to an extent upon income for the taxable year 1942, nevertheless, the tax assessed is for the 1943 taxable year and not for the 1942 taxable year. If the income for the taxable year 1942 is greater than the income for the taxable year 1943, then the 1943 tax is substantially the tax, computed at the rates provided in the Internal Revenue Code, on the income for the taxable year 1942, plus 25% of the tax based on the income for the taxable year 1943 similarly computed. On the other hand, if the income for the taxable year 1942 is not greater than the income for the taxable year 1943, then the tax for 1943 is in substance the tax on the income for the 1943 taxable year, computed at the rates provided in the Internal Revenue Code, plus 25% of the tax on the income for the 1942 taxable year similarly computed. All payments made on account of the 1942 assessment, now forgiven, are applied on account of the 1943 assessment. The 25% of the tax computed upon income for the lesser income year may be deferred one-half until March 15, 1944 and the other half until March 15, 1945. There are, of course, provisions in the Current Tax Payment Act relating to a windfall tax, but for the purposes of the discussion here these provisions are not considered.

In view of the fact that the tax for the year 1942[14] is forgiven it would seem clear that where an individual is renegotiated for the year 1942, agreeing to make retroactive price reductions through a refund, he is entitled to no tax credit under Section 3806. On the other hand, it would seem, too, that to the extent that his 1943 tax is based upon income for the year 1942, the individual taxpayer should receive all benefits taxwise of the adjustment to income effected through renegotiation. After a consideration of the matter the Bureau of Internal Revenue issued *I. T. 3619*.[15] In substance *I. T. 3619* provides (a) that where retroactive price reductions made pursuant to renegotiation by an individual affect the year 1942, that individual is entitled to no tax credit under Section 3806 of the Internal Revenue Code, since the liability of the individual for the tax for the year 1942 becomes discharged as of September 1, 1943 and since the payments on account of such tax are considered as payments on account of the tax for the taxable year 1943; and (b) that the taxpayer, however, in estimating his tax for 1943 at September 15, 1943, and December 15, 1943, and in filing his 1943 return on March 15, 1944, may eliminate from 1942 income the excessive profits refunded or agreed to be refunded.

The Current Tax Payment Act of 1943 and *I. T. 3619* has caused consideration of two principal questions by the individual contractor who is renegotiated for 1942. The first question is whether in the long run, since he will receive no Section 3806 credit against excessive profits eliminated, he will be required to repay more dollars in renegotiation refunds and taxes than he would have had to pay had the Current Tax Payment Act not been passed? The second question is, must these dollars in taxes and renegotiation be paid earlier than if the Current Tax Payment Act had not been passed, i.e., how have the demands upon working capital been affected?

[14] Hereafter when a year is referred to the reference is intended to be to a taxable year as defined in the Current Tax Payment Act of 1943.

[15] 1943 INT. REV. BULL. No. 16, at 6-7.

No doubt, at this point, the situation appears very complex. By using examples, however, the situation may perhaps be simplified. For example, let us consider individual Contractor *A* with respect to whom the following facts exist:

1. 1942 income before renegotiation $1,000,000.00
2. 1942 tax computed before passage of the Current Tax Payment Act 855,140.00
3. 1942 excessive profits to be refunded pursuant to renegotiation, all of which he plans to repay in 1942 ..... 500,000.00
4. Taxes computed upon 1942 income adjusted to reflect renegotiation 415,140.00
5. The tax credit to which he would have been entitled under Section 3806 had the Current Tax Payment Act not been passed 440,000.00
6. Income during each of the years 1943 and 1944 ..... 2,000,000.00
7. Tax at present rates for each of the years 1943 and 1944 ..... 1,795,140.00
8. Income for the year 1945 ..... None

It will be seen that the income of Contractor *A* for the year 1942 after renegotiation is not greater than his income for the year 1943. Therefore, his tax for the year 1943 is equal to the tax computed upon 1943 income plus 25% of the tax computed on 1942 income. The tax computed on his 1943 income is $1,795,140. The tax computed on his 1942 income adjusted to reflect renegotiation is $415,140, 25% of which will become a part of the 1942 tax. This 25%, namely, $103,785, is payable one-half on March 15, 1944, and one-half on March 15, 1945. Therefore, his 1943 tax is $1,898,925, of which $1,795,140 is payable in 1943, $51,893 is payable in 1944, and $51,893 is payable in 1945. Contractor *A's* situation before and after the passage of the Current Tax Payment Act based upon the assumptions above set forth appears as follows:

Cash requirements in renegotiation refunds and taxes of Contractor A in the years 1943, 1944 and 1945 before and after the passage of the Current Tax Payment Act of 1943[16]

		1943	1944	1945
Had the Act Not Been Passed				
Federal Taxes	$ 855,140			
Excessive profits refunded for 1942 after application of the Section 3806 tax credit	60,000			
Total taxes and renegotiation refunds		$ 915,140	$1,795,140	$1,795,140[17]
After Passage of the Act				
Federal Taxes	$1,795,140			
Excessive profits refunded for 1942—no Section 3806 credit	500,000			
Total taxes and renegotiated refunds		$2,295,140	$1,847,032	$ 51,893[18]

From a study of these figures it can be seen that if *A* pays his entire excessive profits refund for 1942 in 1943 his cash requirements for the latter year have been

[16] No consideration is given to any renegotiation for 1943 or 1944.

[17] Taxes on 1944 income.

[18] One-half of that part of the 1943 tax based on 1942 income. The other half is in the $1,847,032 figure in the 1944 column.

heavily increased compared to what would have been his cash requirements for that year had the Current Tax Payment Act not been passed. These requirements are $2,295,140 after the Act, compared with $915,140 had the Act not been passed. In order to aid a contractor in this situation the War Department Price Adjustment Board has adopted a policy of allowing the 1942 renegotiation refund to be deferred through the year 1944 if his current position requires it. It can be seen, however, that Contractor A's cash requirements in 1944 continue to be heavy. But this policy gives the contractor time to plan for these cash requirements, and the renegotiation agencies are limited in extending time by the fact that the tax effects described in *I. T. 3619* seem to be effective only if "the taxpayer *before the close of the taxable year following the taxable year 1943 pays* to the United States the entire amount of the excessive profits determined by a renegotiation for the taxable year 1942. * * *" (Emphasis supplied.)[19]

It will also be observed from the total payments required by Contractor *A* in the three years set forth in the foregoing schedule that after the Current Tax Payment Act, he will have paid less in renegotiation and taxes than he would have paid had that Act not been passed. It may be thought that this comparison is without significance since no income has been assumed for Contractor *A* in 1945. To compare the situations of a taxpayer before and after the Current Tax Payment Act the figures must be carried either to the year of his death or to a year with little or no income, one of which events, needless to add, is certain to occur. In any case, however, if the figures of a contractor in *A's* income situation for 1942 and 1943 are carried until the occurrence of either of these events, the total paid in taxes and renegotiation after the Act will not exceed those required had the Act not been passed.

Had the Current Tax Payment Act not been passed, Contractor A would have received a Section 3806 tax credit, equal to the taxes assessed for 1942 on the excessive profits eliminated. Since the passage of the Act a similar benefit is derived through the elimination of these excessive profits from 1942 income in computing the 1943 tax. In the case of Contractor *A* this benefit is limited, however, since only 25% of the tax computed on 1942 income becomes part of the 1943 tax. This, of course, accounts for his heavy cash requirements in 1943. On the other hand, if excessive profits are eliminated for 1943, his Section 3806 tax credit will be equal to the entire tax assessed upon the excessive profits eliminated for 1943, since included in the 1943 tax is 100% of the tax computed on 1943 income.

Contractor *B* finds himself in the following situation:

1. 1942 income before renegotiation	$2,000,000.00
2. 1942 tax computed before passage of the Current Tax Payment Act	1,735,140.00
3. 1942 excessive profits to be refunded pursuant to renegotiation, all of which he plans to repay in 1943	1,000,000.00
4. Tax computed upon 1942 income adjusted to reflect renegotiation	855,140.00
5. The tax credit to which he would have been entitled under Section 3806 had the Current Tax Payment Act not been passed	880,000.00

[19] I. T. 3619, 1943 INT. REV. BULL. No. 16, at 6, 7.

6. Income during the years 1943 and 1944, respectively	50,000.00
7. Tax computed upon income for each of the years 1943 and 1944	27,740.00
8. Income for 1945	None

The 1942 income of Contractor *B* after renegotiation is greater than his 1943 income. Therefore, his tax for the year 1943 is equal to the tax based upon 1942 income, plus 25% of the tax based upon 1943 income. Contractor *B's* situation, had the Current Tax Payment Act not been passed, and after its passage based upon the assumptions above set forth, is as follows:

Cash requirements in renegotiation refunds and taxes of Contractor B in the years 1943, 1944 and 1945 before and after the passage of the Current Tax Payment Act of 1943[20]

		1943	1944	1945
Had the Act Not Been Passed				
Federal Taxes	$1,735,140			
Excessive profits refunded for 1942 after application of Section 3806 tax credit	120,000			
Total taxes and renegotiation refunds		$1,855,140	$27,740	$27,740[21]
After Passage of the Act				
Federal Taxes	855,140			
Excessive profits refunded for 1942— No Section 3806 credit	1,000,000			
		$1,855,140	$31,207	$ 3,468[22]

Unlike Contractor *A*, the cash requirements of Contractor *B* in 1943 for renegotiation refunds and taxes are the same as though the Act had not been passed. This results from the fact that included in the 1943 tax is 100% of the tax computed upon 1942 income, and the fact that only that part of the 1943 tax is payable in 1943. Since 100% of the tax computed on 1942 income is included in the 1943 tax, elimination pursuant to *I. T. 3619* of the renegotiation refund from income for 1942 results in a reduction in the 1943 tax equal to the full tax on the excessive profits eliminated for 1942. Although Contractor *B* pays his renegotiation refund in full without credit under Section 3806, his 1943 tax is, as a result of renegotiation, reduced by an amount equal to the tax credit he would receive under Section 3806 with respect to his 1942 assessment had it not been abated by the Current Tax Payment Act. If, however, Contractor *B* refunds excessive profits for 1943, such refunds will reduce income for the lesser of the two years involved. Therefore, the tax credit under Section 3806 in connection with the 1943 renegotiation will not be the taxes in full computed upon the excessive profits eliminated but only 25%

[20] No consideration is given to any renegotiation for 1943 or 1944.

[21] Taxes on 1944 income.

[22] One-half of that part of the 1943 tax based upon 1943 income. The other half is in the $31,207 figure in the 1944 column.

of those taxes. Here he will find himself in the same position as Contractor *A* finds himself with respect to excessive profits eliminated from 1942 income.

Like Contractor *A*, the total payments of Contractor *B* in taxes and refunds during the three year period under the conditions assumed will not exceed those he would have been required to make had the Current Tax Payment Act not been passed.

IV

By reason of the nature of the Renegotiation Statute and the Internal Revenue Code, new questions will constantly arise involving the relation of the two laws. It will appear from the discussion that has gone before that several principles seem to have governed in solving many of the questions that have already arisen. The first is that the results of renegotiation for a contractor should be substantially the same regardless of whether his renegotiation occurs before or after he has filed his Federal returns for the year affected. The second is that a contractor should not be required to pay taxes upon income refunded pursuant to renegotiation, or be required to refund pursuant to renegotiation income to the extent that he has paid taxes on such income. The third is that administratively the handling of renegotiation and taxation should be such that a contractor will not be required to pay money to one agency of the United States Government and be required to claim a refund from another such agency, based upon the payment to the first. In view of the history of the administration of the Internal Revenue Code and the Renegotiation Statute in their relation to each other it would appear that many of the future questions that may arise offer promise of being settled ultimately through application of these three principles.[23]

[23] Although the relationship of renegotiation and state taxes levied upon or measured by income is outside the intended scope of this article, it may be desirable to indicate briefly the nature of the general problem involved. Under Subsection (c)(3) of the Renegotiation Act state "income" taxes are allowable costs in renegotiation to the extent applicable to renegotiable business. The fundamental question is whether the portion of the state tax attributable to the retroactive price adjustment should be allowed as a cost in renegotiation. There is no question as to the propriety of allowing as a cost the portion of the state tax attributable to the renegotiated profits not deemed excessive.

Based upon the statutory conception that the process of renegotiation is one of over-all repricing, it would seem that for state tax purposes the contractor should be treated as though he had never received the income represented by the price adjustment, that state income taxes on such portion of his income should not be allowed as a cost in renegotiation, and that if he has paid state income taxes on such portion of his income, those taxes should be refunded. Several states, however, have refused to recognize the effect of retroactive renegotiation upon the contractor's income or have given only partial recognition thereto. Analysis of the reasons offered in justification of this position seems to indicate that the basic contention of these states is that the Federal Government should permit the states to retain this portion of the contractor's excessive profits to compensate for loss by the states of other sources of revenue. Whether the states having war contractors should be given a subsidy in this form is obviously a serious question.

Pending clarification of the situation, however, the renegotiation agencies have generally allowed as an item of cost state taxes upon income unreduced by excessive profits eliminated if state taxes upon such income have been paid. The contractor, however, is required to perfect a claim for a refund of state tax based upon the elimination of excessive profits from income, and if refund is made to pay it to the United States. In this connection it is of interest to note that in the Finance Committee version of the Revenue Bill of 1943 there is a direction which would appear to require the renegotiation agencies to allow as an item of cost state income taxes only upon income after being adjusted for excessive profits eliminated. See 403(a)(4)(B) of the Renegotiation Statute, as proposed to be amended by Section 701(b) of the Finance Committee Bill, Revenue Bill of 1943 (H. R. 3687).

CONSTITUTIONALITY OF STATUTORY RENEGOTIATION

CHARLES S. COLLIER*

I

The so-called "Renegotiation Act" was enacted in its original form as part of one of the National Defense Appropriation Acts, which was approved April 28, 1942.[1] The provisions thereof were amended in certain respects by the Revenue Act of 1942,[2] approved October 21, 1942, and again in July, 1943.[3] The "Renegotiation Act" as amended[4] is applicable to all contracts for an amount in excess of

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[1] 56 STAT. 245, 41 U. S. C. A. note prec. §1 (Supp. 1942) (Sec. 403 of the Sixth Supplemental National Defense Appropriation Act, 1942).

[2] Pub. L. No. 753, 77th Cong., 2d Sess. (Oct. 21, 1942) (Sec. 801 of the Revenue Act of 1942).

[3] Pub. L. No. 108, 78th Cong., 1st Sess. (July 1, 1943) (Military Appropriation Act, 1944); Pub. L. No. 149, 78th Cong., 1st Sess. (July 14, 1943).

[4] For the purposes of a discussion centering on constitutional issues, it seems desirable to quote verbatim, rather than to summarize, or re-state, the "key paragraphs" of the Act. Although in all probability the Act will be amended by adoption of the pending Revenue Bill of 1943, the basic features of renegotiation giving rise to much of the discussion that follows will remain. The most essential provisions (although there are other provisions of importance) are found in the following passages:

"Wherever in the opinion of the Secretary of a Department, the profits realized or likely to be realized from any contract with such Department, or from any sub-contract thereunder whether or not made by the contractor, may be excessive, the Secretary is authorized and directed to require the contractor or sub-contractor to renegotiate the contract price. * * *

"Upon renegotiation the Secretary is authorized and directed to eliminate any excessive profits under such contract or sub-contract (i) by reductions in the contract price of the contract or sub-contract or by other revision in its terms; or (ii) by withholding from amounts otherwise due to the contractor or sub-contractor any amount of such excessive profits or (iii) by directing a contractor to withhold for the account of the United States from amounts otherwise due to the sub-contractor, any amount of such excessive profits under the sub-contract, or (iv) by recovery from the contractor or sub-contractor through repayment credit or suit of any amount of such excessive profits actually paid to him or (v) by any combination of these methods as the Secretary deems desirable. * * *

"Upon renegotiation pursuant to this section, the Secretary may make such final or other agreement with a contractor or sub-contractor for the elimination of excessive profits and for the discharge of any liability for excessive profits under this section as the Secretary deems desirable. * * * Any such agreement shall be final and conclusive according to its terms and except upon a showing of fraud or malfeasance or a wilful misrepresentation of a material fact such agreement shall not be reopened as to the matters agreed upon, and shall not be modified by any officer, employee or agent of the United States. * * *

"This sub-section shall be applicable to all contracts hereafter made, and to all contracts and sub-contracts heretofore made whether or not such contracts or sub-contracts contain a renegotiation or recapture clause unless (i) final payment pursuant to such contract or sub-contract was made prior to April 28, 1942 or (ii) the contract or sub-contract provides otherwise pursuant to sub-section (b), or is exempted under sub-section i of this section 403, or (iii) the aggregate sales by the contractor

$100,000 made by the War Department, the Navy Department, the Maritime Commission and R.F.C. subsidiaries and to certain classes of contracts made by the Treasury Department. The Act is to remain in force during the continuance of the present war and for three years after its termination. A bill in amendment of the existing law was recently introduced in the House of Representatives by the Chairman of the Ways and Means Committee.[5]

In discussing the constitutionality of Acts of Congress, it is necessary to give appropriate attention to three broad classes of constitutional questions: first, those relating to the basic legislative jurisdiction of Congress over the subject matter in question, the issues as to whether such subject-matter falls within the true scope of the enumerated powers of Congress; second, those relating to whether Congress has in the particular instance attempted to delegate its own "legislative" power to administrative officials or to the courts, or has prescribed a plan which if carried into effect would otherwise violate the constitutional principle of the separation of powers; third, those questions which relate to the character and extent of the impingement upon, and interference with, historically established and legally recognized private rights, privileges and immunities in the application of the Act.

In considering the constitutionality of the Renegotiation Act, the first group of questions relating to the basic legislative jurisdiction of Congress presents no serious difficulty. It seems too clear for argument that Congress has a general power to prescribe the forms and procedures to be followed in making contracts in the name of the United States, and to set up conditions precedent that must be complied with before agreements entered into by administrative officials can become legally binding upon the United States. The power to enter into contracts is indeed not mentioned specifically in the Constitution as a power granted to the Government of the United States. But obviously many of the express powers in the Federal Government, such as the power to borrow money, the power to raise and support armies, and the power to provide and maintain a navy could not be exercised effectively without an implied auxiliary power to enter into binding contracts.

"Powers thus exercised are what are called by Judge Story in his Commentaries on the Constitution, resulting powers, arising from the aggregate powers of the government. He instances the right to sue and make contracts."[6]

The basic power of the United States to enter into binding contracts would doubtless have been implied in any event, for, as the authors of the Federalist very

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or sub-contractor and all persons under the control or controlling or under common control with the contractor or sub-contractor under contracts with the Departments and sub-contracts thereunder do not exceed or in the opinion of the Secretary concerned will not exceed $100,000 for the fiscal year of such contractor or sub-contractor."

[5] H. R. 3687, 78th Cong., 1st Sess. (introduced Nov. 18, 1943). This bill proposing important additional amendments to the existing system was introduced in the House of Representatives by Mr. Doughton, the Chairman of the Committee on Ways and Means. At this writing, it has passed the House and has undergone drastic, and questionable, amendments at the hands of the Senate Finance Committee. Its effect on various phases of renegotiation is discussed in this symposium by Abels, *infra* p. 399. Its relevance to certain aspects of constitutionality will be referred to in this article.

[6] Strong, J., in Legal Tender Cases, 12 Wall. 457, 535 (U. S. 1870).

properly state with regard to resulting powers in general—"Had the Constitution been silent on this head, there can be no doubt that all the partciular powers requisite as a means of executing the general powers would have resulted to the government by unavoidable implication. No axiom is more clearly established in law or in reason than that wherever the end is required, the means are authorized; wherever a general power to do a thing is given, every particular power necessary for doing it is included."[7]

Reliance could properly be placed upon the "necessary and proper" clause of Article I, Section 8, par. (18) of the Constitution, as giving to Congress the power to prescribe the legal requisites of contracts of the United States.[8]

In *Ellis v. United States*,[9] the Supreme Court was called upon to deal with criminal convictions for violations of an Act of Congress which purported to limit the hours of labor of mechanics and laborers employed by the United States *or any contractor or sub-contractor* upon any of the public works of the United States to eight hours per day except in cases of extraordinary emergency. The constitutionality of the Act was upheld, and the conviction of Ellis, an independent contractor for "permitting" his workmen to labor during more than nine hours in a single day, on the construction of a pier at the Boston Navy Yard, was sustained. With reference to the basic power of Congress to insert a statutory term in contracts of the United States, the Court said:

". . . Congress, as incident to its power to authorize and enforce contracts for public works may require that they shall be carried out only in a way consistent with its views of public policy, and may punish a departure from that way. It is true that it has not the general power of legislation possessed by the legislatures of the States, and it may be true that the object of this law is of a kind not subject to its general control. But the power which it has over the mode in which contracts shall be performed cannot be limited by a speculation as to motives. If the motive be conceded, however, the fact that Congress has not general control over the conditions of labor does not make unconstitutional a law otherwise valid, because the purpose of the law is to secure to it certain advantages so far as the law goes. . . . The Government purely as a contractor, in the absence of special laws may stand like a private person, but by making a contract it does not give up the power to make a law, and it may make a law like the present for the reasons that we have stated."[10]

If we compare the Renegotiation Act with the Act whose constitutionality was assailed in the *Ellis* case, it seems plain that the purposes of the Renegotiation Act are more obviously germane to the actual interests of the United States *as a con-*

[7] THE FEDERALIST, No. XLIV (Univ. Classics ed.) 310.

[8] "The Congress shall have power . . . (18) To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers, and all other Powers vested by this Constitution in the Government of the United States or in any Department or Officer thereof."

[9] 206 U. S. 246 (1907).

[10] *Id.* at 256. To the same effect, see Hollis v. Kutz, 255 U. S. 452 (1921).

tracting party than was the purpose of the statutory term limiting the hours of labor under review in the *Ellis* case.[11]

While both statutes involve an impingement upon the private interests and immunities of the independent contractor, the question of adjusting the final contract price concerns the United States in an immediate sense, and does not involve any intrusion into fields historically regarded as reserved to the States. But the hours of labor regulation discussed in the *Ellis* case suggests an ulterior purpose as well as an ulterior motive, and impinges upon the zone of State control over labor questions which was historically accepted prior to the enactment of the National Labor Relations Act of 1935. From this point of view, the doctrine of the *Ellis* case rests upon principles that give greater latitude to the power of Congress to enact statutory terms for contracts of the United States, than would be strictly necessary in order to establish that the subject matter of the renegotiation law falls within the basic legislative jurisdiction of Congress.

It is not necessary in order to support the constitutionality of the renegotiation law to assume that Congress has an unlimited discretionary power to prescribe statutory terms of all sorts for all contracts of the United States. The renegotiation law is, in a generic sense at least, an appropriate means for reaching ends which Congress is constitutionally empowered to secure. This statute has a special and genuine relevance to the appropriate exercise of the war powers of the United States Government. In the first place the renegotiation law is designed to reduce the direct cost of the war to the United States by eliminating excessive profits to private individuals and firms arising out of contracts for war supplies and war services furnished to the United States. In the second place, the statute is designed to place a flexible but effective barrier to rising prices on war-time contracts. The legislation derived much of its support from the belief the proposed renegotiation system would operate as an important agency of price control and that forward prices would be held in check because of the knowledge on the part of all concerned that "excessive profits" would in any event be "recaptured."[12] It must be admitted that the alleged beneficial effect of the renegotiation system on forward prices is widely questioned, and is indeed earnestly denied by many attorneys and accountants familiar with the actual working of the system. But from a constitutional standpoint the colorable purpose and the argumentative effect of the statutory plan in respect to the limitation of future prices support the conclusion that the objectives of the statute are legitimate and lie within the reach of the legislative power granted to Congress under our system of government.

In the third place, the renegotiation system is designed to stimulate greater efficiency in the operation of the various concerns which have war contracts with the

[11] And *cf.* Atkin v. Kansas, 191 U. S. 207 (1903); People v. Orange County Road Const. Co., 175 N. Y. 84, 67 N. E. 129 (1903); People v. Grout, 179 N. Y. 417, 72 N. E. 464 (1904); People v. Metz, 193 N. Y. 148, 85 N. E. 1870 (1908).

[12] PRACTICES IN RENEGOTIATION OF WAR CONTRACTS (published by National Industrial Conference Board, Inc., 247 Park Ave., New York), p. 1.

United States, greater efficiency, that is, as technical production agencies, than would be the case were easy profits assured through lax supervision. In this aspect, the renegotiation system with its constant and anticipated inquisition into the necessity and legitimacy of all cost items and the reasonableness of profits secured by methods of increased efficiency, offers obvious advantages over the easy-going cost-plus-a-fixed-fee basis for determining war contract prices.

Finally, the renegotiation system is designed to strengthen national *morale* by giving assurance that no one will be allowed to make excessive profits out of war industry. This assurance is an important factor in securing the general willingness to make sacrifices of all sorts and to sustain the unavoidable costs of the war. The renegotiation system is designed to operate as a real factor in strengthening the moral unity of the nation and in inducing on all sides the willingness to make the maximum effort for victory.

It seems plain, then, that the *ends* for which the renegotiation system is designed are in themselves legitimate ends which are wholly within the war powers of the United States as contemplated by the Constitution.

As to the legitimacy of the particular *means,* namely, the renegotiation law, for reaching these acknowledged constitutional objectives, the frequently quoted words of Chief Justice Marshall in *McCulloch v. Maryland*[13] seem peculiarly apposite:

"We admit as all must admit that the powers of the government are limited and that its limits are not to be transcended. But we think the sound construction of the Constitution must allow to the national legislature that *discretion with respect to the means* by which the powers it confers are to be carried into execution, which will enable that body to perform the high duties assigned to it, *in the manner most beneficial to the people. Let the end be legitimate, let it be within the scope of the Constitution, and all means which are appropriate, which are plainly adapted to that end,* which are not prohibited but consist with the letter and spirit of the Constitution, are constitutional."[14] (Italics added.)

II

If it be assumed that the subject matter of the Renegotiation Act is within the basic legislative jurisdiction of Congress, there remain many weighty objections to the constitutionality of the Renegotiation Act. Perhaps the most perplexing of these is the objection that the Renegotiation Act delegates unstandardized power to administrative officials and that this attempted action is unconstitutional because it amounts to an abdication by Congress of its primary responsibilities as a legislatve body and an attempted delegation of the entire legislative power of Congress in this field. Subordinate elements in this general objection are, first, that the act permits redelegation of full power in the premises to administrative subordinates,[15] and second, that the administrative officials to whom in effect untrammelled power has been delegated are not obligated by the statute to act quasi-judicially or even to be

[13] 4 Wheat. 316 (U. S., 1819). [14] *Id.* at 421.

[15] Pub. L. No. 753, 77th Cong., 2d Sess. (Oct. 21, 1942) (Sec. 801 of the Revenue Act of 1942).

impartial in an administrative sense, and that they are in fact "partisans" of the claims of the United States since there is no separation of the prosecuting and adjudicative functions in this field of governmental action.[16]

As regards this branch of the discussion it is important to distinguish at the outset between the prospective application and the retroactive application of the renegotiation law.

So far as concerns contracts within the scope of the renegotiation legislation that have been entered into since the operative date of that legislation, April 28, 1942, the statutory authority of the Secretaries to require the contractor or sub-contractor to renegotiate the contract price so as to eliminate excessive profits must be read in as a statutory term constituting an integral part of each such contract. Each contractor and sub-contractor entering into such subsequent contracts must be deemed to have voluntarily assented to the renegotiation provisions. It becomes part of each such contract from the beginning that the final contract price is subject to reductions to be determined in amount by the application of the standard of eliminating excessive profits. This part or aspect of each such contract is as much entitled to legal recognition and enforcement as any other part.[17]

When Shakespeare put into the mouth of Marcus Brutus the words "This is my answer—not that I loved Caesar less but that I loved Rome more"—he set a pattern for many well-balanced legal opinions. The reason for upholding the contractual right of the United States to insist on renegotiation and the elimination of excessive profits as regards all contracts of the specified classes entered into after April 28, 1942, is not that we respect the basic personal liberties and immunities of the independent contractor any the less, but that we respect the special contractual rights of the Government more.

In most instances, in contracts entered into after April 28, 1942, the provision for renegotiation and the elimination of excessive profits has been expressly stated as required by Sub-section (b) of the Act. There will thus be in almost all instances in contracts within the scope of the Act, an express written assent by the independent contractor to the investiture of power in the designated Secretary to require renegotiation, and to eliminate excessive profits. But even if such express contractual provisions were not included in the actual written text of the contracts, the same requirements would have to be read into them as necessary statutory terms.

There appears to be no fundamental reason why a formal contract between the United States and an independent contractor may not reserve to the United States unrestricted discretionary power to determine what rates, prices or charges shall be paid by the United States for property sold or services rendered to the United States by the other contracting party. This proposition, extreme as it may seem, is illustrated by the method of fixing telegraph rates on U. S. Government telegrams which has received continuous legislative and judicial recognition throughout the last 75 years.

[16] *Ibid.* *Cf.* Morgan v. U. S., 304 U. S. 1 (1937). [17] Atkin v. Kansas, 191 U. S. 207 (1903).

In the Post Roads Act of 1866[18] the following provisions were included:

"And be it further enacted, That telegraphic communications between the several departments of the Government of the United States and their officers and agents shall in their transmission over the lines of any of said companies, have priority over all other business, and shall be sent at rates to be annually fixed by the Postmaster General. . . ." (Sec. 2)

"And be it further enacted, That before any telegraph company shall exercise any of the powers or privileges conferred by this Act, such company shall file their written acceptance with the Postmaster General of the restrictions and obligations required by this Act. . . ." (Sec. 4)

In these provisions relating to the rates to be charged for transmitting U. S. Government telegrams, no standard whatever is laid down as controlling the discretion of the Postmaster General in this field of action. There is no specification that the rates shall be compensatory, or even that they shall be such as to reimburse the telegraph companies for the direct or incremental costs incurred in rendering these services to the U. S. Government. Much less is there any implied requirement that the rates fixed shall be such as would be constitutionally requisite in the regulation of public utility rates, where no such contractual terms were involved. The telegraph rates on U. S. Government telegrams have always been fixed under the Act of 1866 at levels below those required for commercial telegrams. For many years these rates were fixed at forty per cent of the rates on corresponding commercial services.

The explanation of this apparent anomaly in public utility law is that the telegraph companies are bound by their contracts given for legal consideration, to accept the discretionary ruling of the Postmaster General (and the Federal Communications Commission in succession to the Postmaster General)[19] as the conclusive determination of the rates to be paid for the transmission of U. S. Government telegrams. The special contractual basis of the powers of the Postmaster General and the Federal Communications Commission has been regarded as sufficient to displace all the ordinary principles of public utility rate regulation that have been developed where no such contractual basis for the utility rates had been formed. This system for fixing telegraph rates has been referred to without disapproval in numerous judicial decisions[20] and must be regarded as consistent with all basic constitutional requirements.

The contractual reservation of discretionary powers to officials of the U. S. Government in the renegotiation laws of 1942 seems genuinely analogous. But the powers reserved to the Secretaries under the renegotiation law, since they refer only to the elimination of "excessive profits" and control only particular contracts or

[18] 15 STAT. 221 (1866).

[19] 48 STAT. 1064, 1102 (1934); 47 U. S. C. 1940 ed. §601(b).

[20] United States v. Union Pacific Ry., 160 U. S. 1 (1895); Western Union Tel. Co. v. Penn. R. R., 195 U. S. 540 (1904); Pensacola Tel. Co. v. Western Union Tel. Co., 96 U. S. 1 (1877); Western Union Tel. Co. v. Ann Arbor R. R., 178 U. S. 239 (1900).

groups of contracts that contemplate full performance within a limited time, are much less arbitrary and much less likely to disturb or undermine the permanent financial basis of the independent contractor's business, than the above-mentioned power of the Postmaster General in the field of the rates on U. S. Government telegrams.

It is important to emphasize the distinction between a standard established for the guidance of administrative officials, and a standard prescribed in a genuine police regulation, intended to be enforced *in invitum* upon all persons to whom it may apply. The standard prescribed for administrative action under the renegotiation law is admittedly a vague one whose meaning has not yet been determined with satisfactory precision. But as regards the prospective application of the law, that is, its application to the renegotiation of contracts entered into after April 28, 1942, the standard prescribed, namely, the elimination of "excessive profits," is *primarily a standard for administrative guidance*. It is applied to outside parties only when they have voluntarily contracted with the United States in terms that purport to bind them to accept final prices which have been renegotiated and reduced in accordance with the authoritative interpretation of this standard.

From this point of view it seems plain that decisions like that in the *Cohen Grocery* case[21] are not apposite in relation to the prospective application of the renegotiation law. In the *Cohen Grocery* case, the Supreme Court was required to pass upon the constitutionality of the Lever Act of 1919 which made it unlawful "for any person wilfully to make any unjust or unreasonable rate or charge in handling or dealing in or with any necessaries."[22] No administrative body had been given authority to fix prices or to specify by detailed prescriptions what rates or charges were unjust or unreasonable. The statute was held void for uncertainty.

The decision in the *Cohen Grocery* case may perhaps be analyzed as a judicial condemnation of an attempt on the part of Congress to delegate legislative power to the courts. It is important to notice, however, that the decision may equally well be rested upon the Fifth and Sixth Amendments, as guaranties of individual liberties against criminal prosecutions in cases where neither the indictment nor the statute are adequate to inform parties charged with criminal misconduct as to "the nature and cause of the accusation."[23] Persons who have never by any special contract with the United States subjected themselves to the control of a system of administrative interpretations of a vague standard established by law cannot be prosecuted criminally on the basis of alleged violations of statutory terms which are in themselves, and prior to any authoritative interpretation, too indefinite to establish any ascertainable standard of criminal guilt.

It should be noted also that the standard condemned in the *Cohen Grocery* case was "an unjust or unreasonable rate or charge."[24] The prohibition against "exces-

[21] United States v. Cohen Grocery Co., 255 U. S. 81 (1921).
[22] 41 STAT. 297 (1919).
[23] *See* United States v. Cohen Grocery Co., 255 U. S. 81, 88 (1921).
[24] Text to note 22, *supra*.

sive prices" appears only in the conspiracy clause of the Lever Act—"it is hereby made unlawful . . . to conspire . . . to exact any excessive prices for any necessaries." Both of these standards seem to require consideration of many more factors than are involved in the concept, "excessive profits." Prices charged by a particular dealer might be "excessive" either in relation to actual costs or merely in relation to general market valuations of the commodities. "Unjust or unreasonable" rates and charges might or might not involve "excessive profits." In addition, the whole difficulty of defining "excessive profits" is potentially involved in the maximum generality of these standards in the Lever Act; for excessive profits might well be a factor in determining by a retrospective judgment what prices have been "unjust or unreasonable." But the Lever Act fails to provide any indication of the relative weight of the factor of excessive profits in the final determination, nor does it set up any administrative process for working out the standard through the contrast and analysis of divergent administrative rulings. The individual had to choose his own course under the Lever Act without any administrative guidance, and subject to oppressive criminal responsibility if his initial guesswork as to the meaning of the "standard" differed from the ultimate, better-informed, retrospective determination of a criminal court. The decision in the *Cohen Grocery* case does not require the condemnation of the renegotiation act.

The question of the legal sufficiency of the standard for administrative action prescribed in the Renegotiation Act must ultimately be faced. This is especially apparent with regard to the retroactive application of the law, for in this field the independent contractors cannot be regarded as having bargained to accept the discretionary judgment of the Secretaries. If the profits of past contracts can be recaptured at all, it must be in accordance with some definite standard of action that is to be consistently and equitably applied. But the legal sufficiency of the statutory standard is also vitally important with regard to the prospective application of the statute.

What then is the standard for administrative action which the renegotiation act as amended, contemplates? Section (a) paragraph 4 of the renegotiation act presents the following highly unsatisfactory substitute for a definition:

"The term 'excessive profit' means any amount of a contract or sub-contract price which is found as a result of renegotiation to represent excessive profits."[25]

Logically, this is not a definition, since the subject and predicate are substantially the same. For practical purposes, however, this attempted definition has some value since it shows that excessive profits are not to be ascertained by any particular formula. The statute attaches the label "excessive profits" to the findings of an administrative process. What is to guide this administrative process? Surely not alone the words "excessive profits," but also the whole plan and purpose of the renegotiation law.

[25] Pub. L. No. 753, *supra* note 2.

Legal standards are always hard to define. What are "reasonable rates" for a public utility concern? What are reasonable as distinguished from unreasonable combinations in restraint of trade? What is "due care under the circumstances," the lack of which is so frequently provocative of tort liability? What are "good motives" and "justifiable ends" in the law of criminal libel? No precise definitions of these standards can be quoted. Yet the terms are pregnant with meaning and have a practical value as intelligible criteria in current judicial and administrative work.

There is, however, one very significant difference between the recognized legal standards just referred to, and the standard of "excessive profits" and that is the historically developed content or connotation of meaning which at the present time is associated with such standards as "reasonable rates" for public utility concerns.[26] With regard to the standard of "excessive profits" this connotation is lacking, for we are at an earlier stage of the typical historical development of the meaning of standards through the process of inclusion and exclusion and through the approach and contact of authoritative decisions of divergent tendencies.

The most important effort to establish by administrative interpretation a concrete meaning, reasonably capable of consistent practical applications, for the statutory conception of "excessive profits," is the "Joint Statement" relative to "purposes, principles, policies and interpretations" under the Act issued by the War, Navy and Treasury Departments and the Maritime Commission, under date of March 31, 1943.[27]

The "Joint Statement" declares that the price adjustment boards are guided by the following broad principles: "(a) That the stimulation of quantity production is of primary importance." "(b) That reasonable profits in every case should be determined with reference to the particular performance factors present without limitations or restriction by any fixed formula with respect to rate of profit or otherwise." "(c) That the profits of the contractor will be determined on his war business as a whole for a fiscal period, rather than on specific contracts separately. . . ." "(d) That as volume increases, the margin of profit should decrease. . . ." "(e) That in determining what margin of profit is fair, consideration should be given to the corresponding profits in pre-war base years of the particular contractor and for the industry, especially in cases where the war products are substantially like pre-war products. . . ." "(f) That the reasonableness of profits should be determined before provision for federal income and excess profits taxes." "(g) That a contractor's right to a reasonable profit and his need for working capital should be distinguished. A contractor should not be allowed to earn excessive profits merely because he lacks adequate working capital in relation to a greatly increased volume of business."[28]

[26] Trustees of Saratoga Springs v. Saratoga Gas, E. L. & P. Co., 191 N. Y. 123, 83 N. E. 693; Schechter Corp. v. United States, 295 U. S. 495 (1935).

[27] JOINT STATEMENT BY THE WAR, NAVY AND TREASURY DEPARTMENTS AND THE MARITIME COMMISSION (March 31, 1943).

[28] *Id.* at 7.

The Joint Statement also declares: "In determining the margin of profit to which a contractor is entitled, consideration is given to the *manner in which the contractor's operations compare with those of other contractors* with respect to the applicable factors; among such factors taken into consideration when applicable are the following:

(a) Price reductions and comparative prices.
(b) Efficiency in reducing costs.
(c) Economy in the use of raw materials.
(d) Efficiency in the use of facilities and in the conservation of manpower.
(e) Character and extent of sub-contracting.
(f) Quality of production.
(g) Complexity of manufacturing technique.
(h) Rate of delivery and turnover.
(i) Inventive and developmental contribution with respect to important war products.
(j) Cooperation with the Government and with other contractors in developing and supplying technical assistance to alternative or competitive sources of supply and the effect thereof on the contractors future peace-time business."[29] (Italics added.)

If this statement of controlling principles had been enacted by Congress as an integral part of the original renegotiation statute, we should probably be "safe" in concluding that Congress has discharged its basic legislative duty with respect to prescribing a standard for the guidance and direction of administrative boards empowered to recapture "excessive profits."[30] Congress, on this supposition, would have given us a piece of legislation sufficiently explicit, definite, and certain to satisfy constitutional requirements. The Revenue Bill of 1943, therefore, which sets up standards analogous to those in the Joint Statement, would seem to settle this issue of constitutionality with respect to fiscal years ending after June 30, 1943, the effective date mentioned in the Bill.[30a]

Now, may the "Joint Statement" issued on March 31, 1943, by administrative officials charged with the duty of enforcing the less articulate renegotiation statute that Congress did actually enact, be accepted as the legal equivalent of express statutory terms? The question is peculiarly important with regard to the intermediate period between April 28, 1942, when the renegotiation statute first became operative, and March 31, 1943, when the Joint Statement was promulgated, and became available as an authoritative guide to practice under the statute.

In favor of an affirmative answer, the following considerations may be assembled: first, we are not dealing with the enforced application of a police statute generally upon all the citizenry, as to which reasonable certainty, definiteness and

[29] *Id.* at 8.

[30] Hampton Co. v. United States, 276 U. S. 394 (1928); United States v. Darby, 312 U. S. 100 (1940); Panama Refining Co. v. Ryan, 293 U. S. 388 (1934) and annotation thereon in 79 L. Ed. 474-582.

[30a] *Supra* note 5.

clarity in the terms of the statute itself are constitutionally requisite. We are dealing with a standard which, however, unsatisfactory intrinsically has been contractually accepted by individual citizens and corporations who have also agreed to the authoritative interpretation of the standard by officials of the United States Government.[31]

Second, we are dealing with a standard laid down primarily for administrative guidance, and intended to be given color and content by intelligent and systematic administrative action, before being finally applied to actual business situations. In this respect, the criteria of the statute might be compared to the "public interest" criteria which appear in many statutes now generally acquiesced in; for example the provisions in Sections 5(b) and 5(e) of the Interstate Commerce Act dealing with consolidations and combinations of carriers. By the terms of the statute just referred to, the Interstate Commerce Commission is authorized to approve such combinations, when falling within certain broad classifications "if the Commission finds" "the proposed transaction . . . will be consistent with the public interest."[32]

Third, it must be kept in mind that what the Constitution requires in such matters is merely that Congress should make the essential legislative choices, should lay down appropriate standards for administrative action and should indicate with clearness the objectives at which interpretation and enforcement should aim.[33] It is not constitutionally requisite that Congress should lay down precise rules, although, of course, Congress *may* prescribe such rules in its own formal enactments, if it chooses to do so. But where subject matter renders the exact delineation of detailed rules impracticable or undesirable, Congress in many instances has in its own primary legislation, merely prescribed broad and flexible standards leaving the detailed rules to be worked out by administrative bodies. It is an intelligible standard and not a body of precise formated rules which is constitutionally requisite. In order to establish the constitutional validity of the renegotiation act, it is not necessary to show that the legislation of Congress embodies a definite *rule* or *rules* which cover the ground and operation of the statute in a complete and exhaustive manner. It is merely necessary that Congress should have established an intelligible and adequate *standard* to govern administrative action and guide private parties in the ascertainment and vindication of their legal rights in the premises.

It seems plain that the determination of what profits are excessive is the gist of the renegotiation law. Since Congress has failed (unless it adopts the pertinent provisions of the pending Revenue Act of 1943) to provide an explicit definition, the only alternative means of securing a reasonable precise standard was for the renegotiation authorities either to promulgate formally a comprehensive interpre-

[31] *Cf.* Western Union Tel. Co. v. Penn. R. R., *supra* note 20; United States v. Cohen Grocery Co., *supra* note 21; International Harvester Co. v. Kentucky, 234 U. S. 216 (1914).

[32] N. Y. Central Securities Co. v. United States, 287 U. S. 12 (1932); Texas v. United States, 292 U. S. 522 (1934); United States v. Lowden, 308 U. S. 225 (1939).

[33] Buttfield v. Stranahan, 192 U. S. 470 (1904); Hampton Co. v. United States, *supra* note 30; Panama Refining Co. v. Ryan, *supra* note 30; McKinley v. United States, 249 U. S. 397 (1919); Schechter Corp. v. United States, *supra* note 26.

tation, or to develop a thoroughly consistent practice through their successive adjudications. In either case, the standard thus arrived at could be supported as the "intended" legislative standard, on the ground that a highly generalized and vaguely expressed statement of the standard in the actual words of the statute had been given definite content and character by administrative interpretation. The Boards could treat the statutory language *as if* that language contained an explicit standard to govern their action.

But if, in spite of the formulation of the standard set forth in the Joint Statement, the renegotiation authorities in fact should exercise their discretionary power in such a manner that no consistent rules or principles can be extracted from the actual process, then we should after all reach the stage where we have a government of men, and not of laws in this particular field of governmental action.[34]

If we compare the standard for administrative action proposed in the renegotiation law with the defective standards in various statutes which have in fact been condemned by the United States Supreme Court, it seems plain that the renegotiation standard, vague and unsatisfactory as it appears in the bald sentences of the statute, is more readily capable than were any of the condemned "standards" *of being made certain and definite* for practical purposes by a process of systematic interpretation and application.[35] *Id certum est quod certum reddi potest.* This optimistic maxim could not be justifiably applied with regard to the defective standards contained in the National Industrial Recovery Act of 1933, for example.[36] The standard in the Renegotiation Act at least points the direction in which administrative interpretation should proceed. Furthermore the field of permissible interpretation is relatively narrow. It is confined to what might properly be designated a single subject. Under the National Industrial Recovery Act, the field of possible action included every aspect or element in an extremely wide range of subjects.[37] But furthermore that Act did not supply the fundamental directional principle[38] or principles in accordance with which the administrative development of the incredibly numerous details might possibly have been organized. As compared with the National Industrial Recovery Act, the Renegotiation Act relates to a limited field and the administrative rulings concern themselves with a particular issue—the elimination of excessive profits. The renegotiation boards do not have a roving commission to make rules about all sorts of industrial practices, as did the Code Authorities under the National Industrial Recovery Act, but are required to give

[34] "Though the law itself be fair on its face and impartial in appearance yet if it be applied and administered by public authority with an evil eye and an unequal hand so as practically to make unjust and illegal discriminations between persons in similar circumstances, material to their rights, the denial of equal justice is still within the prohibition of the Constitution." Yick Wo v. Hopkins, 118 U. S. 356, 373-4 (1886).

[35] International Harvester Co. v. Kentucky, *supra* note 31; United States v. Cohen Grocery Co., *supra* note 21; Panama Refining Company v. Ryan, *supra* note 30; Schechter Corp. v. United States, *supra* note 26.

[36] 48 STAT. 195 (1933).

[37] Schechter Corp. v. United States, *supra* note 26.

[38] *Cf.* Panama Refining Co. v. Ryan, *supra* note 33.

their attention, "legislative" though it may be, to the attainment of a single though vaguely defined objective, the elimination of excessive profits.

A good contemporary example of delegated power which is unstandardized to a questionable extent, from a constitutional standpoint, can be taken from the Second War Powers Act.[39] The foundation of the numerous regulations as to priorities issued under the authority of the War Production Board, is deemed by most persons who have examined the matter to be laid in the following brief statutory passage:

"Deliveries under any contract or order specified in this subsection (a) may be assigned priorities over deliveries under any other contract or order, and the President may require acceptance of and performance under such contracts or orders in preference to other contracts or orders for the purpose of assuring such priority. *Whenever the President finds that the fulfillment of requirements for the defense of the United States will result in a shortage in the supply of any material or of any facilities for defense or for the private account or for export, the President may allocate such material or facilities in such manner, upon such conditions and to such extent as he shall deem necessary* or appropriate in the public interest and to promote the national defense."[40] (Italics added.)

Based fundamentally on this broad legislative authorization, many administrative orders of great importance have been issued. For example the Director of Industry Operations of the War Production Board (pursuant to a redelegation of this authority) has issued General Imports Order M. 63,[41] and other orders of like character, which prohibit the importation into the United States of long lists of specific commodities, for private account, except where specific exception is made by authority of this Director of Industry Operations.

As compared with the Second War Powers Act, the Renegotiation Act seems to offer an equally definite standard. The objective of the one act is to eliminate "shortages" of essential war materials and facilities. The objective of the other is to eliminate "excessive profits." In both cases, Congress has made plain the *direction* in which the administrative effort in the interpretation and application of the law must move. But the reliance in both cases has been upon statutory terms whose meaning turns upon words in common use, "shortage" and "excessive profits," presented in the statutes without definition or elaboration. Perhaps the term "shortage" seems to have a superior clarity, because it suggests a mathematical admeasurement of supplies to actual military needs. But the *risks* of shortage must be determined in advance of the actual military needs and the actual administrative practice is to plan the adjustment of supplies to needs with the easement of a very large "factor of safety." The standards available for computation in this field of "shortages" prospective and potential offer fully as wide a field for discretionary

[39] 56 STAT. 176, 50 U. S. C. A. App. §§631 ff. (Supp. 1942).
[40] 56 STAT. 178, 50 U. S. C. A. App. §633 (Supp. 1942).
[41] 7 FED. REG. 4198 (1943).

choice, as do the competing standards that may be brought into play to determine the value of the terms "excessive profits" under the renegotiation law.

There remain, however, two differences between these two statutory problems. First, the term excessive profits is more readily *capable* of exact definition than is the term "prospective shortage." It was not truly *necessary* to delegate such unstandardized power to the renegotiation boards. In the field of priorities it was unavoidable that a practically untrammelled flexible discretion to estimate the risks of shortages should have been delegated by Congress to the administration. Second, the priorities system is so close to the primary war effort, that the nature of the war powers of Congress perhaps justified the delegation of unstandardized power in the field of determining what sorts of shortages immediate or remote, intense, or slight, would make appropriate the application of priorities orders. Perhaps this power inheres in the constitutional prerogatives of the Commander-in-Chief in time of war, irrespective of any express delegations by Congress.[42] But in the case of profits on war-contracts, while the nature of the war powers of Congress justifies some basic regulation, there seems to be no "military *necessity*" for a special adjustment or relaxation in this field of regulation in respect to the precision of the standards which Congress, in order to discharge its constitutional duties, ought to prescribe.

While, however, the term "excessive profits" is *capable* of being defined with precision in an accounting sense, it is very doubtful whether such a definition would express the will of Congress. The changes in the renegotiation law recently agreed upon by the Ways and Means Committee of the House of Representatives[43] show that this Committee intends that the renegotiators shall "consider" such imponderable factors as "the contractor's efficiency" and "the extent of the risks he assumes," and "the nature of his contribution to the war effort" as well as "the potential financial burden to reconvert to peace-time operations." It seems clear that some at least of these factors can never be estimated with the precision of accountancy methods. The intended basis for the estimation of "excessive profits" remains different in essence as well as in detail from the precise and mathematical basis prescribed in other sections of the Revenue Acts for estimating the amount of excess profits for the purposes of excess profits taxation.[44]

It may be added that administrative practice under the Renegotiation Act has not adopted the same exclusions and deductions allowed in the Internal Revenue Code, despite the provision in the Renegotiation Act for recognizing exclusions and deductions of that "character,"[45] so that even the benefit of that reference for supplying a standard is lacking.

[42] *Cf.* United States v. Curtiss-Wright Corp., 299 U. S. 304 (1936).
[43] *Supra* note 5.
[44] Internal Revenue Code, Chapter 2, Subchapter E, Excess Profits Tax, Sec. 710-752.
[45] By amendment in Pub. L. No. 753, 77th Cong., 2d Sess. (Oct. 21, 1942).

III

The third main branch of our discussion must concern itself with what are usually called "due process" questions. The chief of these questions is as to the general validity of the retroactive provisions of the renegotiation law.

Subsection (c)(6) of the Act provides:

"This subsection shall be applicable to all contracts and sub-contracts hereafter made, and to all contracts and sub-contracts heretofore made whether or not such contracts or sub-contracts contain a renegotiation or recapture clause."

Exceptions to the general sweep of this provision are made with relation to cases in which final payment has been made pursuant to the contract, prior to April 28, 1942, and cases involving contracts which have been specifically exempted under the provisions of the Act.

Can the flexible renegotiation provisions under discussion be made applicable, consistently with constitutional safeguards, to contracts and sub-contracts entered into prior to the operative date of the Act, April 28, 1942, in the very numerous cases in which such contracts or sub-contracts contained no renegotiation or recapture clause?

It has frequently been pointed out that the familiar clause in Article I, Section 10, of the Constitution: "No State shall . . . pass any . . . Law impairing the Obligation of Contracts," does not in terms apply as a restriction upon the legislative power of the United States. From this, the inference has been drawn that the Congress of the United States is not restricted by any constitutional limitation with respect to the retroactive application to prior contracts of statutes otherwise within its power to enact.[46] We need not pause, in questioning this inference, to explore the implied limitations on the powers of Congress which its questioning would present; rather, suffice it to say that much of the ground covered by the contract-impairment conception is covered, as interpretations have turned out, by the provision of the Fifth Amendment that "no person shall . . . be deprived of life, liberty or property without due process of law" and the kindred clause "nor shall private property be taken for public use without just compensation." Furthermore these clauses inhibit abrogation,[47] or any arbitrary modification of the legal incidents,[48] of contracts of the United States itself. The protection against federal legislation which would have the effect of divesting previously valid contractual rights, is certainly not limited to instances of purely private contracts, or to contracts to which the United States is not a party.

In *Perry v. United States,*[49] the Supreme Court was required to determine the permanent obligatory force of specific contractual agreements of the United States—namely, the agreement in bonds of the United States to pay principal and interest

[46] Legal Tender Cases, 12 Wall. 457 (U. S. 1870); Julliard v. Greenman, 110 U. S. 421 (1884); Block v. Hirsch, 256 U. S. 135 (1921).

[47] Lynch v. United States, 292 U. S. 571 (1934).

[48] Perry v. United States, 294 U. S. 330 (1935).

[49] *Ibid.*

of the bonds in gold coin of the standard of "value" legally established when the bonds were issued—as against subsequent legislation of Congress which provided that every obligation, whether or not containing such a "gold clause" should "be discharged upon payment, dollar for dollar, in any coin or currency which at the time of payment is legal tender for public and private debts."[50]

Chief Justice Hughes in analyzing the special nature of public obligations of the United States in the course of the majority opinion in this case, said:

"In authorizing Congress to borrow money, the Constitution empowers Congress to fix the amount to be borrowed and the terms of payment. By virtue of the power to borrow money" on the credit of the United States, "the Congress is authorized to pledge that credit as an assurance of payment as stipulated, as the highest assurance the Government can give, its plighted faith. To say that the Congress may withdraw or ignore that pledge is to assume that the Constitution contemplates a vain promise, a pledge having no other sanction than the pleasure and convenience of the pledgor. This Court has given no sanction to such a conception of the obligations of our Government."[51]

And as if to illustrate that this principle was not confined to the formal contract in public bonds of the United States payable in money, the Chief Justice quoted the following broad language from the Sinking Fund Cases, a controversy turning on the question whether certain action was warranted by a reservation to the Congress of the right to amend the charter of a railroad company.

"The United States are as much bound by their contracts as are individuals. If they repudiate their obligations, it is as much repudiation with all the wrong and reproach that term implies, as it would be if the repudiator had been a State or a municipality or a citizen."[52]

While the due process and just compensation clauses of the Fifth Amendment are by no means identical in purpose and scope with the clause in Article I, Section 10, forbidding State laws impairing the obligation of contracts, yet they may well establish constitutional limitations that will produce similar practical effects in many legal situations.

In discussing the concurrent operation of the diverse powers of the state and national governments upon the same subject matter, Chief Justice Marshall made the following illuminating statement in the course of his much rehearsed opinion in *Gibbons v. Ogden:*

"All experience shows that the same measures, or measures scarcely distinguishable from each other may flow from distinct powers; but this does not prove that the powers themselves are identical. Although the means used in their execution may sometimes approach each other so nearly as to be confounded, there are other situations in which they are sufficiently distinct to establish their individuality."[53]

[50] 48 STAT. 112 (1933), 31 U. S. C. 1940 ed. §463.
[51] Perry v. United States, 294 U. S. 330, 351 (1935).
[52] *Ibid.*
[53] Gibbons v. Ogden, 9 Wheat. 1, 204 (U. S. 1824).

A similar statement might be made with equal propriety as to the partially coinciding or analogous operation of different constitutional *limitations*. The restraining effect of the impairment of contract clause upon the States may be "scarcely distinguishable" from the restraining effect of the due process clause of the Fifth Amendment upon the national government in *some situations*. This does not prove that the limitations themselves are identical. There are other legal situations "in which they are sufficiently distinct to establish their individuality."

Where the United States seeks through legislative action to abrogate contracts, and to divest the property rights which independent contractors have in contracts with the United States which were admittedly initially valid and obligatory, this action may well be regarded as legally "voided" by the restrictive force of the due process and just compensation clauses of the Fifth Amendment.

In *Lynch v. United States*,[54] a decision in which a statute of Congress repealing "all laws granting or pertaining to yearly renewable terms insurance" was held unconstitutional, this argument was stated with classical simplicity and directness in the unanimous opinion of the Supreme Court delivered by Mr. Justice Brandeis.

"The Fifth Amendment commands that property be not taken without making *just compensation*. Valid contracts are property whether the obligor be a private individual, a municipality, a State or the United States. Rights against the United States arising out of a contract with it are protected by the Fifth Amendment. . . . When the United States enters into contract relations, its rights and duties therein are governed generally by the law applicable to contracts between private indivduals. That the contracts of war risk insurance were valid when made is not questioned. As Congress had the power to authorize the Bureau of War Risk Insurance to issue them, the due process clause prohibits the United States from annulling them, unless indeed the action taken falls within the federal police power or some other paramount power."[55]

In the *Lynch* case, while giving contracts between the United States and private parties an impregnable position in most legal situations, the Supreme Court nevertheless left open a large "loop-hole" for possible legislative attack by the qualifying statement "unless indeed the action taken falls within the federal police power or some other paramount power." For the purposes of that particular case the "loop-hole" was not made use of. The court states:

"The Solicitor General does not suggest either in brief or argument that there were supervening conditions which authorized Congress to abrogate these contracts in the exercise of the police or any other power."

But in considering the retroactive application of the renegotiation law, this aspect of the authoritative and otherwise staunchly conservative opinion in the *Lynch* case seems to open up a vista of controversy.

The conception that the obligation and effect of contracts may be altered by action taken under the police power is derived from decisions in cases of several

[54] *Supra* note 47. [55] *Id.* at 579.

different groups. First, there are the cases where performance of a contract between private parties that was initially valid under the law of the State having appropriate jurisdiction has been rendered impossible by an exercise of federal power directed toward some recognized federal objective. The contractual obligation is displaced as an incidental result of the exercise of a federal power legitimate in itself. In this classification we may place the first of the Gold Clause Cases[56] and cases like the *Louisville Railroad* case.[57] Second, there are the cases dealing with the revocation of corporate charters, which authorize activities such as the operation of a lottery, or the maintenance of what would amount to a nuisance at common law. These charters are held to be "congenitally defective" as contracts. The states' police power cannot be bargained away. Although such charters have a tentative initial validity, they are not contracts protected by the clause forbidding legislative impairment in Article I, Section 10 of the Constitution. Decisions which illustrate this classification are those in *Stone v. Mississippi*[58] and *Beer Company v. Massachusetts*.[59] Third, there are cases in which certain classes of agreements which are regarded as contracts in many legal situations are held to be outside the protection of the impairment clause; for example, marriage contracts, *Maynard v. Hill*,[60] and executory agreements for the payment of salaries or commissions to state employees, *Butler v. Pennsylvania*.[61] Fourth, there are cases where legal incidents attaching originally to private contracts are held subject to abrogation, because they conflict with some legitimate state policy embodied in appropriate legislation *which, however, leaves unchanged the most substantial elements of the rights secured* under the contract by virtue of the law originally applicable. Examples of this classification would be state laws abolishing imprisonment for debt,[62] state laws altering some of the incidents of the ownership of real property,[63] and laws altering the rules of legal procedure in relation to the enforcement of contracts which leave available a substantial practical remedy for the protection of all existing contract rights.[64]

It seems entirely plain that the renegotiable contracts entered into by the various governmental agencies prior to the effective date of the Renegotiation Act does not fall within any of the categories just distinguished.

Since these contracts are entered into by the accredited agencies of the United States, on behalf of the United States itself in a substantial sense as the real party in interest in every case, there is no room for the application of the remote analogy of cases where legislation supervening upon private contracts formed under existing law has been held to have the effect of displacing or modifying the initial private rights and obligations arising out of such contracts. The war contracts to

[56] Norman v. B. & O. R. R., 294 U. S. 240 (1935).
[57] Louisville & Nashville R. R. v. Mottley, 219 U. S. 467 (1911).
[58] 101 U. S. 814 (1880).
[59] 97 U. S. 25 (1878).
[60] 125 U. S. 190 (1888).
[61] 10 How. 402 (U. S. 1850).
[62] Penniman's Case, 103 U. S. 714 (1880).
[63] Eldridge v. Trezevant, 160 U. S. 452 (1895).
[64] Terry v. Anderson, 95 U. S. 628 (1877); Morley v. Lake Shore Ry. Co., 146 U. S. 162 (1892); Home Bldg. & L. Assn. v. Blaisdell, 290 U. S. 398 (1934).

which the renegotiation statute is addressed would seem to fall within the category illustrated by *Perry v. United States*,[65] rather than within the category illustrated by the first *Gold Clause* cases.[66] These contracts do not involve any attempt to "bargain away essential powers of the Government," but are separable specific contracts whose obligations leave the general regulatory powers of the United States wholly intact. Such contracts therefore bear no resemblance to the "perishable" charter contracts under consideration in cases like *Stone v. Mississippi*.[67]

It is certainly doubtful that a statute providing for the recovery of profits earned by the independent contractors can be regarded as the sort of modification by retroactive legislation which leaves unchanged the most substantial rights under the contracts, while only minor incidents are altered. Obviously this statute is not a mere modification of legal procedure. It is not fundamentally a moratorium statute with appropriate safeguards for both debtor and creditor, and does not therefore fall within the authority of decisions like the *Minnesota Moratorium* case.[68] Furthermore the underlying policy of the renegotiation law is directed in its primary aspect to altering the obligation and effect of the contracts as an end in itself. It aims at "levelling the inequalities of fortune."[69] The renegotiation law cannot be regarded as a statute directed primarily to the accomplishment of ulterior objectives, which incidentally and perhaps unavoidably displaces technical contract rights. The law upheld in the *Minnesota Moratorium* case had as its genuine primary objective the preservation of the class of independent farmers and home owners whose existence was theatened by the burden of their debts in a period of acute financial crisis and whose transformation into tenant farmers or itinerant laborers, uprooted from their own freeholds, would have involved sociological and moral consequences of the most serious sort.

On the other hand, may it not be said that the consequences sought to be avoided by the Renegotiation Act are fully as serious? After making due allowances for the benefits of "incentive," are not excessive profits derived from supplying the means to combat the common enemy, at a time of national danger and general sacrifice, as abhorrent as the prospects of an economically submerged class? True, it might be argued that in the renegotiation law the primary objective is a levelling of advantages derived from contracts established by free bargaining and that the attack on large profits derived from such contracts is an attack on the free enterprise system; also, that contracts made under a system of free enterprise between parties among whom the Government departments are certainly not the least powerful and made for business purposes with profits contemplated by all concerned as likely to accrue to the independent contractors, can hardly be analyzed as having "congenital defects" which from their first formation expose them to retroactive legislative attack and deprive them of the protection of paramount constitutional safeguards. Again, it might be argued that the constitutional safeguards in ques-

[65] *Supra* note 48. [66] *Supra* note 56. [67] *Supra* note 58.
[68] Home Bldg. & Loan Assn. v. Blaisdell, *supra* note 64.
[69] Coppage v. Kansas, 236 U. S. 1, 18 (1915).

tion were intended to protect the system of free enterprise and to preserve to contracting parties and property holders the fruits or advantages which they had gained by their business activity and their bargaining capacity; and if such contracts as these war contracts are vitiated by "congenital defects" in a constitutional sense, then the exceptional case has become the controlling rule, and all or nearly all business contracts will be found subject to retroactive legislative displacement. But these arguments should be evaluated against the hard facts, in the background leading to renegotiation, that the sinews of war were urgently needed, that the "free" market of classical economics was absent, that the types of materials used were often new and their costs unknown. Finally, even if no "new" articles were involved, cannot the legislative power come to the relief of the buyer in a seller's market, even if the government itself is the buyer?

War contracts of the type covered by the renegotiation law have, of course, in certain circumstances been regarded as falling outside the range of the "congenital defect" doctrine, as is well illustrated by the decision and the reasoning of the Supreme Court in the recent *Bethlehem Steel* case.[70] This case was a suit in equity, brought by the United States against Bethlehem Steel Corporation and its industrial subsidiaries for an accounting and for the recovery of sums paids under contracts for the construction of ships built for the United States under various wartime contracts entered into in 1917 and 1918. The Government argued that these contracts were invalid because unconscionable, specifying that the contracts were obtained under practical duress and that the profits were so grossly in excess of a standard established by common practice as to be accessible to recovery on equitable principles. Recovery was denied in the District Court, and this ruling was affirmed by the United States Supreme Court. In commenting upon the controlling issues, the Supreme Court said:

"The profits claimed here arises under contracts deliberately let by the Fleet Corporation under authority delegated by the President in accordance with an Act of Congress. *Neither Congress nor the President restricted the freedom of the Fleet Corporation to grant measures of profit common at the time.* And the Fleet Corporation's chosen policy was to operate in a field where profits for services are demanded and expected. The futility of subjecting this choice of policy to judicial review is demonstrated by this case. . . . *Under our form of government we do not have the power to nullify it as we believe we should necessarily be doing were we to declare these contracts unenforceable on the ground that profits granted under Congressional authority were too high.*"[71] (Italics added.)

Are the profits accruing under war contracts made prior to April 28, 1942, "granted under Congressional authority" in the same sense as the profits obtained by the Bethlehem Steel Corporation and its subsidiaries in the period of the first World War? Did the rights of independent contractors which accrued prior to the actual enactment of the renegotiation law become legally "vested" in accordance with the

[70] 315 U. S. 288 (1942).

[71] *Id.* at 308.

doctrine announced in that case? (The case, be it noted, was rendered on February 16, 1942, with full cognizance of its implications under contemporary wartime conditions.) Or is there a distinction between a court's refusal to lay down, without statutory sanction, a common law (or equity) contract doctrine of economic duress and the constitutional validity of a statute?

The probability is that the Supreme Court will in the end give sympathetic recognition to the considerations that militate in favor of the constitutionality of the present renegotiation statute even in its retroactive application. In the first place, some of the war contracts made prior to April 28, 1942, may be found to be positively unconscionable within the sphere allowed for that concept, even under the liberal views expressed by the majority of the Supreme Court in the Bethlehem Steel case.[72] In the second place, while the contracts made prior to the statute are formally complete, it seems possible, in view of the extreme urgency of the Government's military needs and the novelty of the industrial and accounting problems that had to be faced, to develop a doctrine that these contracts did not create rights of property that should be regarded as legally "vested" in all respects. From a factual standpoint these wartime contracts have had an experimental character in many instances. It would not be altogether surprising if, against a background of haste, lack of informative data, experimentation and tenuous moral claims to large profits at public expense in times of universal sacrifice, the Supreme Court should hold that contracts subject to renegotiation should be classified as possessing only a tentative or precarious validity in a legal sense, that is, as not creating legal rights so fully vested as to be protected by constitutional guarantees against any sort of reasonable and equitable "corrective" legislation. As Mr. Justice Daniel said in *Butler v. Pennsylvania*[73] with reference to the scope of the clause forbidding state laws impairing the obligation of contracts: "The contracts designed to be protected are contracts by which *perfect rights,* certain definite *fixed private rights of property* are vested. These are clearly distinguishable from measures or engagements adopted or undertaken by the body politic or state government for the benefit of all, and from the *necessity of the case. . . .*"[74] (Italics added.)

In spite of the lack of any specific precedent, it seems possible to recognize in these wartime agreements for the furnishing of war necessities, a special classification of contracts that because of the circumstances of their origin are subject to the potentiality of subsequent legislative adjustment. The "congenital defect" theory could, both in a logical and in a practical sense, be extended to cover this additional and limited class of contracts, without endangering the security of "perfect rights,"

[72] "For, high as Bethlehem's 22% profit seems to us, we are compelled to admit that so far as the record or any other source of which we can take notice discloses, it is not grossly in excess of the standard established by common practice in the field. . . . The Government made no attempt to establish, nor is there any indication in the record that the profits realized by other shipbuilders were any less than Bethlehem's." U. S. v. Bethlehem Steel, 315 U. S. 288, 305, 306. The dissenting opinion of Mr. Justice Frankfurter has special significance with regard to the probable judicial attitude in more extreme cases of "unconscionable" war profits. 315 U. S. 288, 312.

[73] *Supra* note 61.

[74] *Id.* at 416.

fully vested rights of property, except in the same sense that these vested rights are already endangered by the admitted recognition of the "congenital defect" theory in other appropriate situations.

And in the third place, the admitted constitutionality of retroactive income and excess profits taxation extending back over comparable periods of time, indicates that excessive profits, unlike most other terms and incidents of contracts, are not in their essential nature beyond the reach of federal legislation. While the formal differences between renegotiation procedure and excess profits taxation are obvious, the practical differences in the ultimate results are relatively small, especially if we consider the more searching forms which excess profits taxation might take, without violating constitutional limitations. Special income taxes applicable exclusively to income from certain designated sources have already been resorted to, as in the instance of the special tax on the profits of sales of silver.[75] The only kind of uniformity that is constitutionally requisite with regard to income and excess profits taxation is geographical uniformity.[76] There is no fundamental reason why a *special income tax* could not be laid on the excessive profits gained from contracts for necessary war supplies.

The most hopeful basis for attacks on the rulings under the renegotiation law would therefore seem to be, not the basic constitutionality of the statute, but the maladministration thereof in specific cases, if such can be demonstrated. In this field as in other fields the rights secured to the individual under procedural due process must be observed. Arbitrary discrimination, radical unfairness in procedural methods, or intentional disregard of the practical standards which the statute must be regarded as laying down, cannot be reconciled with constitutional safeguards. Such abuses will doubtless be recognized in appropriate instances as grounds for judicial relief, but such cases should be dealt with on an individual basis, and ought not to be disposed of through a blanket condemnation of the entire statutory plan.

[75] 48 STAT. 1178 (1934).

[76] United States v. Hudson, 299 U. S. 498. The Silver Purchase Act of June 19, 1934, imposed on all transfers of any interest in silver bullion, where the sale price exposed a profit over the original cost and allowed expenses, a tax of fifty percent of such profit. The tax was to be paid by affixing to a memorandum of the sale stamps to the amount of the tax. The tax was analyzed by the Supreme Court as a *special income tax*, and upheld as constitutional on this basis.

In delivering the unanimous opinion of the Supreme Court in this case, Mr. Justice Van Devanter said:

"The taxing provision does not impress a tax in respect of all transfers but only in respect of such as yield a profit over cost and allowed expenses. If there be no profit there is to be no tax. If there be a profit the tax is to be 50% of it. Because of this, counsel for the Government contend that *the tax is a special income tax;* and *we think the contention is sound.*

It is not material that such profit is taxed, along with other gains, under the general income tax law, for Congress has the power to impose an increased or additional tax, if satisfied there is need therefor." (Italics added.)

RENEGOTIATION: PRO AND CON

HULT LAWRENCE WILSON*

"Hither came Jack Spicer and talked of Exchequer matters and how the Lord Treasurer hath now ordered all monies to be brought into the Exchequer, and hath settled the King's revenues and given every general expense proper assignments; to the Navy £200,000 and odde. He also told me of the vast trade of the goldsmiths in supplying the King with money at dear rates." PEPYS'S DIARY, December 29, 1662.

I. INTRODUCTION

The problem of economical procurement of the weapons of war is not new. The recurrence of war merely presents the question in new dress. Jack Spicer and the inimitable Pepys may have thought they were conducting a sprightly and unique discussion. But others had argued such matters previously, and the discussion continues unabated today. There may be novelty in the modern note, however. If there is, it is in connection with the procedure which is labelled "renegotiation."

True, renegotiation is not entirely new. The history of states whose power was embodied in autocratic sovereigns is replete with instances of ex post facto adjustments of loans, for example. At times the lender was put off with promises of one kind or another, again he received a monopoly or a grant instead of the repayment of gold—and sometimes he was "liquidated." These various policies might be called "renegotiation" of a sort. Renegotiation on such a level would be no novelty. But the faith which the citizen placed in the stability of state obligations had latterly grown to such stature (almost one of the "folkways" of modern business) that any change in the nature of such obligation, such as renegotiation, would result in immediate protest.

When one of the members of Congress says:

". . . there is no such thing as a contract with the Government any more. The businessman is obligated to the Government, but the Government is not obligated to him. You don't need a law to renegotiate. This is just a play on words. That implies mutual consent. Anybody can amend a contract by mutual consent. This isn't renegotiation. This is price adjustment, what you really call it, but there is no contract with the Government any more, is there?"[1]

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[1] *Hearings before Committee on Naval Affairs pursuant to H. Res. 30*, 78th Cong., 1st Sess. (1943) Vol. 2, 517-8.

he is giving voice to the fear, to the almost visible shiver that runs through the body of business at the slightest whisper that the days of autocratic sovereignty vis-a-vis business might return.

Two observations may be made at this point. First, business and government are involved in a confusion of frames of reference. Renegotiation, its advocates have sometimes insisted, is identical with economical procurement; more, it is the only method of such procurement. Frequently the opponents of the statute have permitted themselves to be taken in by this assumption. Renegotiation is but *one* of the means of economical procurement—there are others.

That renegotiation is not the only method by which excessive profits may be recaptured is evident from the testimony of the former Chairman of the War Department Price Adjustment Board before the Ways and Means Committee:

"In the last 25 years, there have been no less than 170 bills introduced into the Congress for the elimination and control of war profits."[2]

Second, it would appear that semanticism had achieved a triumph through passage of the renegotiation law. The principle of multiple definition had been applied—and the public had accepted "renegotiation" where it might have rejected "price adjustment."

Definition of "negotiation" is normally given as "deliberation, discussion, or conference upon the terms of a proposed agreement; the act of settling or arranging the terms and conditions of a bargain, sale, or other business transaction."[3]

In the light of the definition it cannot be gainsaid that war contracts, in the main, were "negotiated." Agreement may not come so readily on the proposition that the proceeding termed "re-negotiation" is anything like a second negotiation, deliberation, discussion or conference upon the terms of a proposed agreement, or arranging terms of a bargain, sale, or other business transaction.

Certain quarters would more probably claim that the correct term should have been "re-dictation." This, again, would be incorrect, since in the vast majority of cases, the original contract was not dictated, but negotiated. The shift in meaning, apparent through the use of the foregoing examples, evidences the fundamental disagreement between the affirmative and negative side of the question of renegotiation.

Having called attention to these two areas of confusion, the discussion of renegotiation's pros and cons will continue on the assumptions: (1) that renegotiation is not economical procurement in its entirety; (2) that renegotiation must be accepted as descriptive of the methodology used, regardless of opinion as to its definition.

On two points there is agreement: (1) the immorality of excessive profits; (2) the ability of the price adjustment boards. As to the first, it would be a hardy individual indeed who would attempt the position that excessive war profits should not be

[2] *Hearings before Committee on Ways and Means on H. R. 2324, 2698 and 3015*, 78th Cong., 1st Sess. (1943) 3, September 9, 1943.

[3] BLACK, LAW DICTIONARY.

avoided. The witnesses at the present and prior Congressional hearings were unanimous on this point. As well argue against the tenets of the Lord's Prayer. It might be that some peace advocate should have advanced an argument: Since war itself is economically wasteful, perhaps war procurement should be as wasteful as possible, because only through a world-wide acceptance of the total economic loss which attends war, would we arrive at possibilities of continued world peace. But no such argument was presented.

As to the second: the efficiency and the fairness of the members of the price adjustment boards, their ability and background, have been fully recognized. With over fifty of such boards in the various departments and agencies, the fact that such outstanding groups of business men can be brought into work which for them involves a break in their normal working careers speaks most highly for the determined efforts of the directors of the policy in government to provide as equitable procedure as possible. In considering the work of the armed forces on renegotiation, it should be remembered that any one of 22,000 contracting officers, at one time or another, might be called in to handle certain aspects of renegotiation.

On the Navy Department Board sits a partner of one of the outstanding public accounting firms in the country; a president of a leading investment banking house; an outstanding attorney; other prominent accountants, lawyers, engineers and industrialists. Similar prominence is evident in the membership of other boards. These men know business and its problems, they are not theorists. They give of their years of experience in a conscientious effort to reduce the cost of war.

Because renegotiation is so novel in conception and so recent in operation, because it touches both the advocates of free enterprise and government control to the quick, the writer has found in the utterances of the actors in the drama as played before various Congressional committees the most vivid attacks and defenses. In presenting the pros and cons, therefore, in two sections of this article, numerous quotations will be given. Indulgence of readers who are not overly fond of reading "chamber drama" is asked. At the same time assurance is given that no substitute statements could be as vital as those spoken words reported in the hearings of the Congressional committees. The Jack Spicers and Samuel Pepys' of 1943 have devoted time, ingenuity, sincerity and no small amount of heat to this battle.

Treatment of the pros and cons involved in the debate over renegotiation procedure will be grouped under the following headings: War Profits Controls in Other Countries, Arguments for Renegotiation, Arguments Against Renegotiation, Striking the Balance.[4]

[4] Discussion of economic and juridical aspects of renegotiation are to be found in a number of recent law reviews: Steadman, *Renegotiation of War Contracts* (1943) 42 MICH. L. REV. 1; Judson, *The Renegotiation of War Contracts* (1943) 10 U. OF CHI. L. REV. 193; LaBrum, *Some Recent Developments in Renegotiation of War Contracts* (1943) 91 U. OF PA. L. REV. 714; Withrow, *The Control of War Profits in the United States and Canada* (1942) 91 U. OF PA. L. REV. 194; Notes (1943) 11 GEO. WASH. L. REV. 227; (1942) 37 ILL. L. REV. 155; (1942) 16 SO. CALIF. L. REV. 31. Also, Patterson, *Renegotiation: What It Is: What It Does: How It Works* (Jan. 1943) DUN'S REVIEW, 8.

II. WAR PROFITS CONTROLS IN OTHER COUNTRIES

What is done about the profits picture in Britain, in Canada, in Germany, in Russia? Here we may find in four countries—two with a politico-economic system close to ours, one with a system admitting some private profit but asserting state supremacy, one with a system generally denying private profit—interesting comparisons.

1. *War Profits Control in Britain.* The Parliamentary Select Committee on National Expenditure in its Fourth Report[5] comments on government procurement procedure in the following words:

"It has been quite apparent, for instance, that the departmental officers who have propounded some of the more complicated types of contract have sometimes used terms which are misleading or conceptions which the business man has failed to understand; and in other cases they do not appear themselves to have understood the full implications of their proposals. To contractors who are anxious to co-operate with Departments to the full, this vagueness is a source of worry and irritation, while to others it provides loopholes for evasion, and in all cases causes an avoidable waste of time and money in complicated and unnecessary negotiations."[6]

The British use four types of adjusted price contracts (1) cost plus a percentage, (2) cost plus a fixed profit (or management fee), (3) maximum price, (4) target cost (with a limit on payment of excess over the target). The Select Committee states that the two types of cost plus contracts "have no other merit than simplicity."[7] And further:

"The Committee recognizes that in cases of urgency such types of agreement may be necessary; they also recognize simplicity as a characteristic of great importance. As to the maximum price contract they state it should be combined with a target cost; target cost contracts, they say, should be applied to 'novel products in their early stages before a fair fixed price can be set for straight-run production.' "[8]

Britain, with a 100 per cent excess profits tax, has no renegotiation statute. However, in connection with the various adjusted price contracts, "post costing" or "auditing" after production has been completed, in order to determine direct costs and allowance of overhead costs, is used.

As to such post costing the Committee reports:

"If prior estimation can be sufficiently close for the setting of a target cost or maximum price, post costing will be applied to determine the final price paid and the bonus, if any, earned by the contractor for keeping his costs below the target figure. When no estimate is possible, post costing provides no more than an independent assessment of direct costs and a check on the overheads allowable. But post costing should be used for the detailed information it can be made of to yield on the price structure of articles which are to be the subject of further contracts."[9]

[5] FOURTH REPORT FROM THE PARLIAMENTARY SELECT COMMITTEE ON NATIONAL EXPENDITURE (Jan. 23, 1941).
[6] *Id.* at 6.
[7] *Id.* at 8.
[8] *Id.* at 9.
[9] *Id.* at 15.

And the Committee further says:

"The weaknesses of this system as now used lie partly in the types of contract to which it is applied . . . partly in the impracticability of putting it into effective operation on a very large scale and partly in the failure of Departments to apply the system so as to produce a minimum of dislocation with a maximum of result."[10]

And again:

"The vast numbers of contracts with a costing clause which have been, and are still being placed by the Ministry of Supply alone are well beyond what existing staffs could hope to keep abreast of if detailed costing is to be applied sufficiently rapidly to allow of use being made of the figures in placing further contracts or fixing prices. Apart from this, the delay, inconvenience and disturbance of production caused by full and detailed costing is in some cases considerable and is likely to increase as the supply and the standard of ability of additional cost accountants become less satisfactory.[11]

The absence of an over-all renegotiation act in Britain, with provision for recapture of profits, may have been the cause for this statement:

"The evidence indicates that all the cost investigator can do is to bring abnormally high costs to notice and, unless the firm changes its methods or something is done by the Department to improve the firm's efficiency, there is no reason to expect a reduction in future costs."[12]

On another phase of the 'costing" problem, the Committee adds that:

"It has been stated on behalf of firms in contractual relations with more than one Ministry, or even with different branches of the same Ministry, that the costing methods employed may vary from department to department and that there may be cost investigators from two departments separately taking out figures for the same product ab initio, and without making adequate use of the firm's own accounts."[13]

In Britain, of course, there is an excess profits tax at the rate of 100 per cent, and accordingly, to a large degree the question of rates of profit has not been so far to the front. Yet the Committee did make certain comments on profits. It regarded the proposal of "standard rates" and stated:

"It is recognized that in fixing any standard rates a number of variable factors must be taken into consideration in each case, such as whether the work is novel or repetitive, the rapidity of turnover, the proportion of subcontracting and the amount of assistance from public funds. But the elimination of unnecessary bargaining on each individual contract offers such important advantages that every effort should be made to arrive at standard rates calculated with reference to a fair return on capital employed."[14]

The suggestion had already been acted upon by the Costings branch of the Ministry of Supply which computes profit as a certain percentage of capital employed whenever a contract is "costed." And it was reported in the hearings of

[10] *Id.* at 15, 16.
[11] *Id.* at 16.
[12] *Id.* at 21.
[13] *Id.* at 17.
[14] *Id.* at 22.

the Ways and Means Committee that more recently England is allowing 7½ per cent, before taxes, on invested capital.[15]

It is seen, following the arguments presented in the quotations from the Report, that Britain, having a certain amount of renegotiation in connection with many contract types and profits thereof, is still operating without renegotiation recapture of excessive profits. These are supposedly taken care of through the 100 per cent excess profits tax.

In its recommendations, moreover, the Committee had this statement to make on the question of profits:

"Rates of profit should be related to capital employed; and that some degree of uniformity is highly desirable; but, since a simple fixed rate is hardly feasible, agreements to cover particular industries should be encouraged, though some flexibility should be retained to offer special incentives for special efforts."[16]

2. *War Profits Control in Canada.* The Canadians have not adopted over-all renegotiation as we know it. They have been the foremost promoters of the "target price contract." The development of the system was due, perhaps, to the fact that most items of munitions made in Canada were based on British prototypes. *The Economist* (London) in describing the system had this to say:

"Usually the price of the British manufacturer was converted into Canadian dollars. The Canadian contractor was allowed the target price—usually the British price plus a small profit—as a basis upon which to get into production on a portion of the initial contract, say 10 to 20 percent. The price was subject to audit. If manufacturing became more efficient and costs were found to be falling the contractor was allowed his costs plus profit—the prevailing profit has been 5%. In addition, as an inducement to efficiency, he was allowed a percentage of the spread between the original target costs and his actual cost."[17]

This type of contract has been adopted in the United States and is used today by the Army to a considerable degree.

If the contract form is advantageous in Canada and works in the United States, it is quite possible that the future use of renegotiation can be considerably reduced.

3. *War Profits Control in Germany.* Under-Secretary Patterson's article on renegotiation[18] dealt so authoritatively with German war contracts procedure that it has become a basic source for that phase of the world-wide government procurement problem. The Under Secretary first called attention to the fact that prices paid in Germany for war materiel are not set for each individual firm on the basis of its costs, but "are based in general on the costs of a group of suppliers and correspond to those of a representative producer within that group." Thus all manufacturers whose costs are within the lowest range are put in one group; other manufacturers with higher costs are classified in other groups. The prices are

[15] *Hearings before Committee on Ways and Means, supra* note 2, at 79.
[16] FOURTH REPORT, *supra* note 5, at 36.
[17] THE ECONOMIST (London, September 5, 1942) 303.
[18] *Supra* note 4, at 11-12.

enforced as well as in the case of contracts previously made and contractors may not refuse to accept an order or delay delivery on the ground that the price is out of line. Manufacturers in the lowest cost group are given a reward through a provision that their profits will not be subject to the excess profits tax deductions. Such firms also are given favored treatment with respect to priorities for materials and labor. Firms not in this category are accordingly at a disadvantage. If contract orders are to be cut the higher cost firms will lose such orders first.

The power of the state under the German contracting system, it is seen, goes far beyond the mere question of excessive profits. Its main aim has been to keep production at a high level during the war. By so doing, and with the efficiency and reduction in costs forced by the war, German industry would be prepared, in the minds of German leaders, to enter foreign markets after the war.

The German contract and profit control system, it will be seen, is far more stringent than the renegotiation procedure which has been developed in the United States.

4. *War Profits Control in Russia.* "In the Soviet Union the land, industry, the banks and the transport system are state property, that is, belong to the whole people."[19]

In the light of the foregoing and in view of the well-nigh universal conception of the state ownership "of everything" in Soviet Russia, how is it possible to speak of war profits in that country?

An interesting article by John N. Hazard of the Division of Soviet Supply, Office of Lend-Lease, on Russian Government Corporations[20] helps to bring to mind the fact that corporations do have profits in the Soviet Union. Thus, from profits a fund must be set up for improvement of workers' conditions. This sum is taken from the profits of the corporation at the rate of 10 per cent.

In such corporations the administrative responsibility is in the hands of the director of the corporation.

"The director is held responsible under the criminal code if his enterprise produces goods which are below the standards set for the industry. Penalties for this offence have been increased since the outbreak of the present war to a term of from 5 to 8 years imprisonment."[21]

But much of the procedure of business is similar to that prevailing in other economies. Written contracts are entered into for purchases and sales of materiel. These contracts often contain the conditions needed in working out the plans called for under the over-all economic planning of the state.

The profit and loss position of the corporations is reported frequently. Says the author referred to above:

[19] JOFFE, ECONOMIC PLANNING IN THE U. S. S. R. (Foreign Languages Publishing House, Moscow, 1939) 8.
[20] Hazard, *Soviet Government Corporations* (1943) 41 MICH. L. REV. 850.
[21] *Id.* at 860.

"If the profit and loss statement of a corporation shows a loss when it is filed monthly and at the end of the year with the Commissariat of Finance to which the corporation is responsible and with the corporation's branch of the State Bank, as required by law, either of two conclusions may be drawn. The management has not come up to expectations or the planned prices are at fault. A review is made by the Commissariat to determine which is the cause. If the profits were larger than expected, either the management has proved more efficient than anticipated or prices were erroneously set. A review will likewise determine the cause. . . . By introducing this state accounting system the government inaugurated a method of automatic control requiring inspection only in cases of unexpected variation from the anticipated result. It also introduced a record which management could affect by good or bad work and thus provided an incentive to greater personal effort."[22]

World-wide Similarities. This brief survey of war profits control methods (other than taxation) used in four leading countries, reveals that irrespective of the economy prevailing in each country, profit control through contracts (1) aims at reducing the cost of goods produced; (2) attempts to achieve this end either by setting definite cost limits prior to the contract or by post-auditing; (3) aims at assuring incentives, by providing some sort of bonus, premium or advantage, so that war materiel will be produced at a high level of output. All of them have an inescapable common denominator: they do interfere with the internal management of the business by compelling revelation of accounts and reports. What American proponents and opponents think of the system of profit control worked out in our renegotiation procedure is revealed in the following sections of this article.

III. ARGUMENTS FOR RENEGOTIATION

The wrench to American conceptions of contract stability, to the ideal that legal processes should operate under law rather than men, brought about by renegotiation, is not minimized even by its proponents.

In opening his testimony before the Ways and Means Committee, the former chairman of the War Adjustment Board said:

"In my judgment as an individual, it (renegotiation) is a dangerous and un-American statute, but we are in a dangerous and destructive war which justifies unusual precautions and conditions."[23]

The Under Secretary of the Navy, speaking before the House Naval Affairs Committee, stated:

"Neither I, nor, I am sure, the Under Secretary of War, welcomes this task. It would be far simpler if we could leave the recovery of excessive earnings to some other agency or to an automatic machinery. That is the easiest path. But I could not in conscience say to you that I believe that there is any formula by which excess profits could be prevented on an over-all basis.

[22] *Id.* at 866.
[23] *Hearings before Committee on Ways and Means, supra* note 2, at 2.

"Renegotiation is not a perfect solution any more than there is a perfect solution to war. It is too vast, and anyone who would undertake to say that the method used in dealing with this volume of business was the perfect one, I think wouldn't be competent to appear before your committee. There are no perfect answers. But this we believe is the nearest and the best that we have found to date."[24]

All the arguments in favor of renegotiation must hang on the central point: inordinate profits must be prevented in war time—but at the same time sufficient profits must remain to provide an incentive for efficient war material production.

The savings effected by the renegotiation procedure will no doubt be more fully treated in other articles in this publication.

In general, however, the savings have been effected (1) through recapture of excessive profits and (2) through reduction in prices to be paid for materiel on future delivery.

The total savings reported on September 9th to the Ways and Means Committee by Mr. Karker was $3,955,845,000. Of this sum recaptures accounted for $1,787,923,000 and price reductions $2,167,922,000.[25]

These total savings were the result of 4,866 cases reviewed up to the end of July, 1943. These were not contracts, it should be remembered, but cases of various contractors some of whom may have held numerous government orders.

The examination of these cases revealed that about 40 per cent of the contracting companies had not made excessive profits. The excessive profits of the remaining 60 per cent of contractors ran about 16 to 16½ per cent of selling prices. On the total of contracts covered, the recoveries and the price reductions combined amounted to about 10 per cent of selling prices. Somewhere between 6 and 7 per cent of the contracting companies lost money on their production for war.[26]

What was the cost of this activity to the government? Estimated annual expenses of the War Department Price Adjustment Board were given as $3,522,300;[27] Navy Department expenses were estimated at $750,000.[28] What may have been estimated or spent by other renegotiating agencies would probably not bring the total costs above $5,000,000.

That renegotiation has resulted in substantial savings cannot be successfully denied. Later figures will no doubt show more economies.

The above savings might be reduced by deducting the amount which would have been collected through the excess profits tax. But in spite of that deduction, say its advocates, the ultimate savings would still be huge.

The proponents of renegotiation, over and beyond the savings to which they could point, were also of the opinion that renegotiation had not injured the financial position of the companies renegotiated. Thus one member of the Ways and Means Committee introduced a report showing effects of renegotiation on 28 cor-

[24] *Hearings before Committee on Naval Affairs, supra* note 1 at 410, 411.
[25] *Hearings before Committee on Ways and Means, supra* note 2, at 92, 93.
[26] *Id.* at 93, 94.
[27] *Id.* at 13.
[28] *Hearings before Committee on Naval Affairs, supra* note 1, at 449.

porations; seven of these had not had their 1942 net earnings per share reduced by renegotiation, while numerous others had been reduced in earnings by comparatively small amounts per share.[29]

In addition, the Under Secretary of War called the Ways and Means Committee's attention to the fact that the Government had at its command certain other powers which it could have used in placing contracts which might have resulted in much more serious financial positions for contracting firms:

"He (the contractor) is in no worse condition than he would have been at the outset if we had not agreed upon a price and we had seen fit to place a mandatory order with him, because of the exigency of war, at a price of our own setting, and what we thought was a fair price. We do that largely today. It is necessary that we should do it, of course, for the conduct of the war."[30]

In summary of the position of those defending renegotiation, it may be said that the procedure has resulted in savings; that in the over-all picture of business, while it has reduced some earnings, there is no instance given of a case in which a firm was forced to close its doors because of renegotiation. Finally, there remains the possibility that the government might have used the "mandatory order" procedure, and refrained from doing so, relying rather on the incentive of reasonable profit and the patriotic endeavor of the producer to make as much materiel as he possibly could.

When this is said, the main argument for renegotiation has been given. It is at this point that the difficulties of constitutionality, definite formulae for settlement, the right of appeal, etc., enter the picture. These are very serious objections, they go to the heart of the American way of life—they are the arguments against renegotiation.

IV. THE ARGUMENT AGAINST RENEGOTIATION

It has become almost traditional to lead off every presentation of reasons against renegotiation with a statement of its main fault: that it is a law not of principle but of men. While that is truly its great defect, let us first examine further the financial accomplishments of the law.

1. *Savings effected by renegotiation are not correctly stated in light of tax recoveries.*

According to the estimate of the National City Bank of New York, 70 per cent of the total amount recovered would have been collected through the excess profits tax.[31] The correctness of the estimate may be checked against the statement of the War Department's Price Adjustment Board's former Chairman, who stated before the House Naval Affairs Committee:

"The highest possible corporation tax for 1941 was approximately 72 per cent. The maximum corporation tax for 1942 is 72.8 per cent on over-all earnings of 81 per cent on any increment of earnings, after the post-war credit. Thus so far as a corporation is

[29] *Hearings before Committee on Ways and Means, supra* note 2, at 889.
[30] *Id.* at 826.
[31] *Id.* at 5.

concerned, the minimum difference between recovery in renegotiation and recovery under taxation is 27.2 per cent when the 80 per cent over-all rate is reached and 19 per cent on any increment if the over-all rate is not reached. In many instances the difference is much greater."[32]

If the average figure of 70 per cent is used, then if, for example, a possible 9 billions of dollars might be saved by renegotiation $6,300,000,000 would have been recaptured through taxes and renegotiation savings would have amounted to $2,700,000,000. Such a sum, whether recovered through recapture of profits or by price reductions, is a saving which might be sufficient to overcome many objections.

2. *Of purported savings through renegotiation, a large percentage would have been recovered through contract adjustments.*

The base figure advanced by proponents of renegotiation of $3,955,840,000 included price reductions in the amount of $2,167,922,000. This is 54 per cent of the amount reported as recovered. Figuring this percentage on the sum of $2,700,000,000 which could be saved in the example in the preceding paragraph only through the renegotiation statute, this would give total savings from price reduction of $1,458,000,000. This saving might not otherwise be made since many earlier contracts did not contain price adjustment clauses.

Mr. Karker's figures may be checked with those later submitted by the Under Secretary of War. Reporting on figures for the War Department alone, as of the end of August, Mr. Patterson showed total adjustment of $2,949,000,000 on some $28,100,000,000 of approximate contract value. Recoveries amounted to $1,399,900,000 and price reductions to $1,549,100,000.[33] Here again we have a figure of approximately 10 per cent in savings.

As against this saving and the cost to the government, which has been stated previously, business has claimed that the cost of renegotiation to it has been a heavy burden.

One of the members of the Ways and Means Committee said:

"I went into the office of one large cotton mill that is perhaps devoting less than 20 per cent of its full output to Government material, and they showed me a room in which they had four auditors and eighteen young ladies and men engaged in separating the cost items of this 20 per cent that went to the Government."[34]

During another day of the hearings, the following exchange took place:

"*Mr. Knutson.* I had a gentleman call on me the other day who is in the lumber business. He is connected with one of the larger companies. He told me that they had been put to an expense of about $3,000, after which no renegotiation was had.

"*Mr. Karker.* They had a renegotiation and they presumably had a clearance. But he means he was not required to pay back anything.

[32] *Hearings before Committee on Naval Affairs, supra* note 1, at 1000.
[33] *Hearings before Committee on Ways and Means, supra* note 2, at 820.
[34] *Id.* at 861.

"*Mr. Knutson.* Well, he was not required to pay back, and I am just wondering how much money it has cost American industry to prepare for such an ordeal, out of which nothing came in the way of return.

"*Mr. Karker.* Without question, Mr. Knutson, I think something came out of that, and I think his expenditure of $3,000—assuming that figure is correct—was fairly modest expenditure under those circumstances."[35]

The over-all cost to business, if the average renegotiation costs for preparation averaged $10,000—some may have cost much less, others much more—might run as high as $50,000,000.

But all in all, the conclusion seems inescapable that the cash recovery and price reductions brought about through renegotiation have been very substantial, and at a cost, both to government and business, which does not figure largely when the ultimate recoveries are borne in mind.

No, if renegotiation were to be discarded it would not be on the basis of its expensiveness or its failure to show worthwhile cash savings. It would be rather because of its damage to certain American principles and the possibility that there are other methods which would result in as large savings without violation of those principles.

3. *Renegotiation does not operate on definite principles covering all cases.* Under this objection come such arguments as "renegotiation is a method of men, not of law," "renegotiation does not deal equitably with various firms," "business does not know what to expect," "there is no over-all formula."

An illustration of the combination of these objections in the minds of business men appears in testimony given before the House Naval Affairs Committee by the Vice President of the General Electric Corporation:

"*Mr. Maas.* Mr. Rockey says he has no yardstick and he has no formula. He has a great many factors that are taken into consideration, but he can't tell us any formula for the weight that has to be given to each factor. Do you believe it is feasible or practicable to devise a formula, in general terms at least, upon which renegotiation would be based?

"*Mr. Shreve.* I don't think it is. I think that is one of the reasons renegotiation is not a good approach to the problem.

"*Mr. Maas.* What is there that so disturbs industry about renegotiation?

"*Mr. Shreve.* The uncertainty.

"*Mr. Maas.* The uncertainty of what will be allowed plus the time that it takes?

"*Mr. Shreve.* Right, and the length of time that the books have to remain open, really, before there is any degree of certainty as to what the financial performance of the company has been.

[35] *Id.* at 66.

"*Mr. Maas.* Of course, your books remain open for a long time with the Treasury Department.

"*Mr. Shreve.* We have gotten used to that. This is another one on top of it."[36]

This testimony by an executive of one of the leading corporations of the country is repeated in varying terms by officers of other firms.

Speaking for the Johns-Mansville Corporation, its President, Mr. Lewis H. Brown, said:

"No manager can do any really intelligent planning of his financial future with these uncertainties pending. Nor do we in industry want to look forward to years of litigation and quarreling with our Government. . . . American industry has done a magnificent job of producing the material of war. It has gladly subjected itself to higher tax rates and higher excess profits taxes than it has ever before experienced. If it is necessary to win the war we believe heavier taxes should be levied. If after all these taxes are levied there are profits left that are in fact excessive, then we believe some method such as the renegotiation law should be available to clear up the matter quickly and get it behind us."[37]

Perhaps the apogee of this feeling on the part of business with respect to the renegotiation procedure is found in the testimony of Mr. J. F. Lincoln, President of the Lincoln Electric Company, before the House Ways and Means Committee:

"I talked to you a lot about efficiency. I now want to talk about the last point, and that is the un-American law wherein five men can ruin any industry of this country, and where five men have already, in certain cases, laid the ground work for such ruin.

"I do not believe that the winning of this war is nearly so important as is the freedom of the individual in the United States. If we finish the war in the position which we are in now, in which the executive branch has the right, without recourse, to hold up to any individual the fact that he cannot do anything except at the behest of the Executive, then the United States, as a free country, is gone. . . .

"Now, it is not important, relatively, whether we win this war. It is of outstanding importance whether we continue or ever do regain our liberty."[38]

Mr. Robertson of the Committee, inquiring further into the statement of the witness "that it is not important relatively whether we win the war or not, and that our personal freedom at this time is of more importance than winning the war," received this answer:

"*Mr. Lincoln.* Mr. Robertson, I did not say that. I said this: that, relatively, it is more important that we retain our freedom than it is that we win the war. If we win the war and lose our freedom, we have made no advance over what would have occurred had we lost our freedom—which we would have done."[39]

Continuing the general objection against the renegotiation law, the president of a construction company had this to say:

[36] *Hearings before Committee on Naval Affairs, supra* note 1, at 598.
[37] *Id.* at 541.
[38] *Hearings before Committee on Ways and Means, supra* note 2, at 347.
[39] *Id.* at 348.

"We feel that the renegotiation law is thoroughly un-American and has no place on the statute books of this country. We believe an honest mistake was made by Congress in passing this law, as it did not realize what a destructive instrument had been placed in the hands of the Renegotiation Board. If the Congress feels that more money should be wrung from industry, why not get it over in one operation and increase the tax assessment against corporations, which are already at the breaking point."[40]

Another witness had this to say:

"Since the Board can only renegotiate downward, the contractor knows that he comes in to get clipped. That is why they call the government agencies benzine boards in so many instances. When they are brought in, they know they are in for a cleaning."[41]

Renegotiation proceedings under the administration of thousands of government officials and contracting officers are, of course, subject to the personalities involved. Thus one witness before the Ways and Means Committee said:

"From there I will digress and state it is rather the method which has been taken by the people who came to renegotiate than the fact of renegotiation itself we object to.

"Now, when I attempted to tell the Major from the Department who came to see us I was told the problem we had to go through, he said it was irrelevant and had no bearing, that is your duty. We do not care to discuss it.

"So I said, 'Very well, sir, we have nothing to say. You will have to do the talking and tell us the story and we will listen.'

"So we were told what we could have, what was due us, as partners, and I might say here that in the first year that these young men were organizing this business they were working for far less than they were able to earn in working for others, but with the thought of establishing a business for themselves, they made that contribution.

"As a matter of fact, two of them are married, and partly living on some of the earnings of their wives because we could not get the financial assistance other than I provided from personal funds, and it had to go back in the business to expand it.

"We have no complaint to make about that. We took the risk and we have made some money. Consequently we think we are entitled to some compensation for it, but it seems the officer in charge of renegotiation thinks our effort was not the consequence—when I tried to stress the fact that in view of the fact that we had practically done all of this work on the basis of competitive bids and had therefore contended that our profits were due to efficiency and effort, we were told that was irrelevant also, that 'efficiency' should pay for 'inefficiency,' those words verbatim were said to me, and I desire to insert them in this record."[42]

4. *The renegotiation procedure fails to comply with fundamental legal principles.*

When the Under Secretary of War presented his testimony to the Committee the total effect of complaints as to uncertainty, inequity, rule by men rather than law, came to a climax. Perhaps no better summary of all the pent-up feeling with respect to renegotiation can be found than the exchanges which took place between the Under Secretary and members of the Committee.

[40] *Id.* at 386. [41] *Id.* at 431. [42] *Id.* at 952.

Among the various points brought out during these exchanges were:

(a) The complaint that contractors renegotiated were not given "bills of particulars"—a statement of the manner in which the renegotiation figure was arrived at;
(b) The problem of appeal to the courts for review of the settlement;
(c) Fear of reprisal;
(d) Lack of standards in renegotiation as compared with taxation.

a. *Lack of bills of particulars.* The Chairman of the Committee on Ways and Means, asked these important questions:

"*The Chairman.* If a contractor feels, Mr. Secretary, that he should not refund that which the Renegotiation Board, or those in control of the matters, call upon him to refund, and if they do not give him a bill of particulars, how is he to know whether he has any opportunity to go into court, or whether he should go into court, until he knows the contention of the government?

"*Mr. Patterson.* Well—

"*The Chairman.* If you say I owe you so much money, and I say I do not, and if you do not accept what I say I owe you, then I think you should be able to show some reason why I owe you the amount you say I owe you. That is, I think we should be able, without any prejudice either way, to have some tribunal determine it, to take it into court, where the court can get all the facts. If that were done it seems to me the contractor might very often, if the Government would show him where he owed so much money, be satisfied."

"*Mr. Patterson.* I doubt if the court would tell him, at the end of a complete breakdown that his cost or his profits should be reduced so much, I doubt it; some might.

"*The Chariman.* Do you feel in that respect, under your procedure now, that it is as fair to the contractor as it is to Government?

"*Mr. Patterson.* I believe it is. Suppose, for instance, a contractor has made $60,000,000 profit in a year, and we believe that under all the circumstances, and taking into account everything he presses on us, $30,000,000 is enough, but he should make us give him the reason, and break it down, and say, for the risk involved, $9,900,000, and for the extra services required, so much—I do not think it is possible to do that.

"*The Chairman.* How can you come to a conclusion yourself, if you do not break it down in your own mind? You must have an idea about it yourselves. How can you come to a conclusion unless you break it down and know why he owes so much money?
"*Mr. Patterson.* I think all you can do in that case is to figure out, at the time he took over the contract, how much you would have allowed him as a contract price."[43]

On the same point of a bill of particulars, Mr. Disney of the Committee took up a line of questioning, referring to a previous contractor-witness:

"*Mr. Disney* . . . who (the contractor) said that he was told by the Atlanta office, when he asked for a statement of reasons and facts upon which the decision was based, that your organization could not furnish them to him because that was 'secret criteria.' . . . Pursuing that a little further, under the statute, you are not required, in making a decision as to what are excessive profits, to give the reasons for your decision, are you?

[43] *Id.* at 825.

"*Mr. Patterson.* No, not under the statute, and I do not believe you could give any analysis. You can talk and talk and talk about it. But when it comes down to the final pinch, what you say is, 'Well, in view of all these factors, I think a profit of $1,000,000 is too much on this job and $500,000 would be enough; based upon all my experience and all the factors of the case, and everything.' Then if he says, 'Why just tell me which factors make it unreasonbale,' and so forth, you know very well that that cannot be done in all cases; it just cannot be done.

"*Mr. Disney.* I do not know it, and I never heard of an American court that could not give a reason for his decision; and he is required to. In nearly all jurisdictions, he is required to set out a statement of facts and his conclusions of law."[44]

As can be seen from the foregoing excerpts of testimony, repeated questioning and answers to such questioning, brought no admission that a detailed bill of particulars could be given to contractors. The reason for the insistence on such a bill moved rapidly into a consideration of the next main problem handled by Mr. Patterson.

b. *Appeal to the courts for review of the settlement.*

After the last statement quoted from Mr. Disney, the Under Secretary replied:

"*Mr. Patterson.* Yes, and when it is all said and done, after he (the Court) has done all of that, he says down at the end, 'I therefore find the plaintiff in the sum of so much.'

"*Mr. Disney.* Yes; but the litigant has something to appeal on.

"*Mr. Patterson.* But if the litigant then comes in and says, 'Just tell how much did you allow for this and for this and for this,' the judge tells him to go chase himself.

"*Mr. Disney.* Judge, I am surprised at you, I really am surprised at you; in fact, I am astonished; I am astounded.[45]

"*Mr. Patterson.* You cannot possibly attribute one dollar of value to every single factor in every single case, and put a dollar tag on it and say, 'This is $10 and this is $20.' That is what I mean by saying that."

A few moments later Mr. Disney asked these questions:

"*Mr. Disney.* I am trying to discuss this with you as two lawyers. If we were judges on the Court of Claims, and we take a look at this statute, we would want to know what standards formed the basis for the action of the executive department, or the War Department, would we not? If there were no standards, we would at once, as you said awhile ago, tell the litigant to go and chase himself, because there would be no means except a trial de novo to determine the application of the law, would there?

"*Mr. Patterson.* Well, I did not say the judge would tell them to go chase themselves. I said that if he made an unreasonable demand and opposite each finding or conclusion put a dollar sign, I think the judge would tell them that, and so he would."[46]

Prior to Mr. Disney's questions, Mr. Jenkins, also of the Committee, had said:

". . . And let me say this, and see if I am not right about this. You also gave the impression that a man had easy access to the court.

[44] *Id.* at 844. [45] *Id.* at 844, 845. [46] *Id.* at 845, 846.

"The testimony before us, and the overwhelming testimony, I think the unanimous testimony, was that it is impractical to get into court in these cases. Do you know of any case that ever got into court?

"*Mr. Patterson.* No, I do not know of any case where they finally failed to arrive at a mutual agreement. Several were headed the other way, but the only ones that have come before me have had a mutual agreement.

"*Mr. Jenkins.* When you say 'mutual' agreement, that would imply an agreement with full accord; but you will not admit that there has ever been any coercion at all?

"*Mr. Patterson.* No; there is no coercion. . . .

"*Mr. Jenkins.* I am very sorry I voted for that law with all those things in it. I am very sorry that I voted for that bill when it gave you full and final determination.

"*Mr. Patterson.* Subject to court review, of course.

"*Mr. Jenkins.* That is the point; but how do you get into court?

"*Mr. Patterson.* They can find their way into the courthouse, all right.

"*Mr. Jenkins.* I asked I suppose one of the best and most widely experienced lawyers in that line of business in this country, and he has not been able to get into court. So, so long as you take the attitude, Mr. Secretary—you and your board—that you are right and will not yield, then I want to say to you that you are making a grand mistake.

"*Mr. Patterson.* The only question is whether we have not been too easy on contractors."[47]

Here the excerpts on this problem have reached an impasse. On the one side an insistence on the right to review; on the other side an insistence that there is such a right. It is to be noted that the Lincoln Electric Company may perhaps furnish the first instance of resort to courts, since it has definitely refused the settlement offered on renegotiation of its Navy Contracts.[48]

However, Mr. Patterson stoutly maintained his position in response to questions from Mr. Reed of the Committee.

"*Mr. Patterson.* I will bet you that when they (contract cases) get into court, if any of them take a case to court, any of the cases we have closed, there will not be a single dollar recovered by them.

"*Mr. Reed.* Of course not; we know that.

"*Mr. Patterson.* Because any court would say that the allowance made was a fair and reasonable profit on the business done.

"*Mr. Reed.* They would be bound to, because those are the findings of fact, so that these men cannot get any relief.

"*Mr. Patterson.* I am satisfied that that would be the common public opinion too."[49]

[47] *Id.* at 837, 838.

[48] N. Y. *Times*, Oct. 21, 1943, p. 34, col. 4.

[49] *Hearings before Committee on Ways and Means, supra* note 2, at 839.

c. *Fear of Reprisal.*

Rather than go into specific instances of complaint from business, excerpts will be given from statements by various members of the Ways and Means Committee.

Mr. Jenkins had this to say:

"But I want to say to you that I dare say it will be the unanimous experience of the members of this committee—perhaps I am going too far; perhaps it should be only 90 per cent of the members of this committee—that everybody with whom they have talked, who has been renegotiated, has been dissatisfied.

"One Congressman appeared before us here the other day and said that he had been entertained by 86, I think it was, in his community, and each and every one of them had told him to be sure and not come back to Washington and give the names of any one. I know that every person I have talked with—and I have talked with dozens of them—have told me that I must not mention any names, and that they must not come to Washington."[50]

Mr. Knutson of the Committee said:

"Again I have a peculiar case in mind, and unfortunately I am not at liberty to name the company because of their fear as to what might happen to them if it be found out that they had been contacting members up here on the Hill.

"*Mr. Karker.* That is a very unfortunate inference to leave in the record.

"*Mr. Knutson.* It is unfortunate, but nevertheless it is the situation. We know it. No one can fight the Government. You have the Internal Revenue; you have the Wage and Hour Division; the Social Security Division; and all these other organizations who can at least make life miserable for any one who would not want to go along."[51]

While Mr. Carlson said:

"I think there is a definite fear of reprisal on the part of some of these contractors as to what might happen if they take the matter up with Members of Congress, or appear before the Committee in these hearings. Do you definitely state, to your knowledge, that there are no threats of reprisals or that there will be none?

"*Mr. Karker.* Certainly I, speaking for myself, can say that there has been none, there is none, and there will be none. I think I can speak with equal certainty for the men engaged in renegotiation in the War Department, and by inference, because I know the character of the men who are engaged in this job in other departments, I think I can speak for them. But there are bound to be exceptions. I do not know what they are or where they will arise, but I think the fear is in much greater volume than the justification."[52]

As in the previous discussion of the lack of bills of particulars and access to the courts, one side insisted as sharply as the other that the alleged deficiencies in renegotiation procedure ought not to exist, and did not exist. But, that there is some reason to believe that these difficulties are present cannot, in the main, be denied.

[50] *Id.* at 836. [51] *Id.* at 68. [52] *Id.* at 78.

d. *Lack of Standards Comparable to Tax Procedure.* The ideas of the propounders of the questions addressed to the Under Secretary on this point border on the proposition that taxation might be as efficient a method of recovering excessive profits as renegotiation, and less fraught with the dangers of uncertainty, inequities, duplication of effort, and so on.

One portion of the questioning again centered on the lack of standards in renegotiation, went in to the possibilities of a delegation of the legislative power without any standards. Mr. Disney asked the following questions:

"*Mr. Disney.* If we should attempt to delegate our power to tax which is lodged here and no place else, we would have to do it with standards for the courts to construe, would we not?

"*Mr. Patterson.* Yes.

"*Mr. Disney.* Just as in the 'sick chicken case,' the courts upset the N.R.A. because we had tried to delegate legislative power without any standards.

"*Mr. Patterson.* This could not stand as a taxing act. There is no doubt about that. It is too broad and too general.

"*Mr. Disney.* Then, if it is an indirect delegation of power to tax, it is unconstitutional, is it not?

"*Mr. Patterson.* That is an academic question, Mr. Disney, because no one could read the act and possibly think it was a taxing act."[53]

A short time later Mr. Disney inquired:

"This statute is almost as broad as the Congress writing a letter to the War Department and saying, 'Go to it and collect the excessive profits in any manner that you see fit and to the extent you see fit'—is it not, unless there are standards to guide you?

"*Mr. Patterson.* Well, there are no standards in it except the standard that it shall be fair and just, and I do not know what else you could do. . . .

"I do hope there will be no effort made, though, to write into the law a lot of conditions and restrictions and provisos and standards, and so on, because I am afraid it will be unworkable if we do.

"*Mr. Disney.* Well the excessive-profit tax statute is not unworkable, is it?

"*Mr. Patterson.* No, it is not unworkable.

"*Mr. Disney.* It is not sufficient to meet this situation; is that your judgment?

"*Mr. Patterson.* Well, I do not use it as a taxing statute. It is far more like the mandatory order statute.

"*Mr. Disney.* You figure the excessive-profits statute does not go far enough and take the exorbitant profits. If it did, there would be no necessity for recapture, would there, if the excessive-profits statute were broad enough?

"*Mr. Patterson.* Yes; I agree with you."[54]

[53] *Id.* at 848.

[54] *Id.* at 850, 851.

It might be interesting to go into other objections which were raised by the House Ways and Means Committee and the House Naval Affairs Committee. Thus a number of questions were asked on co-ordination between the various price adjustment boards; whether or not in renegotiation the renegotiators had in mind the non-governmental sales of contractors as well as their governmental sales; inequalities of amounts left with contractors who were in the same line of business; qualifications of the renegotiating officials; the much discussed point of renegotiation before or after taxes; the bilateral or unilateral character of renegotiation.

However, as will be seen in the summary which follows this section, the heart of the pro-and-con of renegotiation is mainly centered around the points which have been presented here through the words of committee members and witnesses.

V. STRIKING A BALANCE

Is it possible to evaluate the arguments for and against renegotiation and come away with a debit or credit balance?

After reading the colloquies which have been quoted, one outstanding impression remains: they were replete with what semanticists term "emotional referants." Time and again the innate and perhaps unconscious prejudices of committee members, and witnesses, came to the surface. When the heat of argument is removed from these colloquies what remains to aid us in forming a final opinion on renegotiation?

To come to any abiding conclusion, it will be necessary to center all contentions under one point, on both the pro and con sides of the discussion.

On the affirmative side we have one word: War.

On the negative side another word: Constitutionalism.

And topping all other considerations is one point: Winning of the war.

The opponents of renegotiation admit this as readily as its proponents—but they insist that the war must be won under constitutional conditions.

What are the subsidiary arguments on both sides?

1. Proponents say that the war must be won with the utmost of economy; that renegotiation achieves this result since it is able to get at excessive profits which might be lost even with the use of a remodeled excess-profits tax. They claim that renegotiation gets the money back *now* when it is needed, and avoids long-drawn out litigation. They assert that by very reason of the lack of set standards and bills of particulars they are able to reward efficiency, low-cost production, speed in production; that renegotiation results in the collection of a body of data which enables the government to obtain more favorable prices.

Stripping the testimony of its emotional referants, it is clear that renegotiation has saved tremendous sums of money, even after giving due credit for sums which may otherwise be recovered through the excess profits tax.

It is true that renegotiation recovers the money *now*.

Through the use of the factors set forth in the Joint Statement the price adjustment boards have been able to reward efficiency, low-cost production, speed in production, novelty in production. The contracting officers, with the body of data which has been secured through renegotiation are in possession of information which aids them in procuring additional material at lower prices.

On the material side of the picture, the dollars and cents side, renegotiation has fulfilled an important mission, it has performed a job which might otherwise have gone undone.

2. The opponents of renegotiation, when in turn their statements are stripped of words of emotional content, are returned almost entirely to their arguments against its unconstitutional aspects; its "un-American" features; instances of alleged injustice; claims that the contractor is not provided with a day in court; that war production is hindered by diverting attention of producers from the main job of producing; that the contractor is not informed of the standards by which his profits are judged; that the recapture of profits leaves contractors in a dangerously weakened condition financially.

It must be admitted that in normal times such procedure as renegotiation would not be usable—there would in the first place be no reason for it. And the chief danger of the renegotiation process may be the possibility that it would become an entering wedge for further interference in private business in time of peace.

What is lost sight of is the fact that in time of war even more sacred constitutional liberties than that of freedom of profits may have to be infringed. Lincoln, during the Civil War, as is well known, suspended the right of habeas corpus. During the last war and this, men have been taken from their personal careers and drafted into the armed forces. Censorship, of one type or another, has been imposed.

That there are instances, perhaps numerous ones, where inequity has resulted, that business may to some extent be fearful of "reprisals"; that there are features of the renegotiation statute which should and doubtless will be changed, must be admitted. That to some degree production may have been slowed down, may also be true.

But if the cost of war should be held to a minimum (and there is no disagreement on that proposition) some means of doing it had to be used. In the United States it was the renegotiation statute.

Perhaps the "constitutionalists" should have been more vocal in their disagreement at the time the act was proposed. They were previously threatened with an over-all 6 per cent profit limitation act—to this there was sturdy opposition at the time. Yet, ironically enough, examination of the figures on recovery of excessive profits shows that the average profit left the contractor under renegotiation has been about 6 per cent. If the principle of constitutionalism was worth fighting for, it should have been defended at the time the 6 per cent limitation was proposed.

Whether or not devotion to principle or the exigencies of expense in fighting a great war, or their combination, resulted in the British excess profits tax of 100

per cent is not to be discovered at this point. However, the Select Committee's report,[55] referred to earlier in this article, had this to say:

"It has been argued that the introduction of an Excess Profits Tax at the rate of 100 per cent makes insistence on the form of contract relatively unimportant. Further, it has been stated that this rate of tax has removed the incentive to cheap production, even from a fixed price contract. This latter argument, though not entirely correct, is supported by evidence, and has considerable weight since it is true that no contractor stands to gain by an increase in his profits above the pre-war standard. It is outside the scope of the Committee's inquiry to consider the reasons for the imposition of the Excess Profits Tax; but the Sub-Committee emphasize that cheap production is vital to the successful prosecution of the war."

In addition to the British 100 per cent excess profits tax the contractor is also specifically limited, at present, to 7½ per cent profit on his contract.

So that despite fears as to the lack of incentives to cheap production, the recapture of excessive profits has also gone on in Britain. And to a certain extent, Britain has a considerable amount of renegotiation, although there it is termed "post-costing" and takes place in specific contracts.

The final conclusion must be:

War is a known economic, physical, spiritual evil. During war each and every element of the community must bear its share of the hardships. To some this is brought home by actual fighting, wounds and death. To others it must mean separation, disturbance of careers, broken plans. Business has to bear its share as well. Its share is not only increased and sometimes difficult production problems, uncertainty as to the future, but also a certain and unpleasant amount of interference with its daily processes.

The inequities of renegotiation are being carefully considered. That there will be amendments to the statute, and that there will be changes in procedure, need not be doubted; witness the proposals of the now pending Revenue Bill of 1943.

Once the changes are in effect, most of the damage of renegotiation will have been corrected, except those to injured feelings and, in a few instances, true, to profits which might have been "rosier" except for renegotiation.

That large sections of American business have been so insistent in their opposition to renegotiation is all to the good. We can never have too many, nor too active, opponents of undue governmental interference. Let us hope that representatives of business will continue as alert in their defense of a proper balance of "true liberties" during the days of peace; that in future normal times there will again be the freedom of all types which the war has interrupted.

For business men who will have felt that their efforts, their long hours, and their successes in producing for war, have been unappreciated; who have flown "E" pennants from their flag-staffs while renegotiation officers were, they felt, failing to give all consideration to their efforts, there remains, in addition to a

[55] *Supra* note 5, at 21.

conviction that renegotiation is un-American, the fact that renegotiation achieved by its much-disliked procedure may some day afford business its greatest comfort.

This possibility was best expressed by the Under Secretary of War at one stage of the Ways and Means Hearing, when, after a long and difficult line of questioning, he said:

"Mr. Jenkins, I will venture a prediction, if I may. That is, that after the war is over and everything is done, there will be a clamor in this country that there was profiteering during the war in spite of renegotiation; and this statute is simply designed to prevent profiteering and a crop of war millionaires."[56]

In that evil day, should it come, businesses which were renegotiated, and particularly where the process was difficult, thorough and unpleasant, will have these proceedings and their settlement agreements to which to point. They may then be happy that they were renegotiated. Because of that procedure they may use the opening words of an old song: "Integer vitae scelerisque purus."

It is to be remembered that true economy in waging a war will redound to the benefit of everyone. Especially is this true in a democracy. One of the profoundest thinkers on problems of statecraft in a chapter entitled "On Liberality and Parsimony" had this to say of state expenditures:

"Since, then, a prince cannot without harming himself practice this virtue of liberality to such an extent that it will be recognized; he will, if he is prudent, not care about being called stingy. As time goes on he will be thought more and more liberal, for the people will see that because of his economy his income is enough for him, that he can defend himself from those who make war against him and that he can enter upon undertakings without burdening his people. Such a prince is in the end liberal to all those from whom he takes nothing, and they are numerous; he is stingy to those to whom he does not give, and they are few."[57]

With proper reforms the renegotiation of contracts will secure this desired end for the American people.

[56] *Hearings before Committee on Ways and Means, supra* note 2, at 837.

[57] MACHIAVELLI, THE PRINCE AND OTHER WORKS (Univ. Classics ed. 1941) 143.

THE 1943 REVENUE BILL'S RENEGOTIATION PROPOSALS

JULES ABELS*

This article, originally planned as a general survey of legislative proposals for amending the Renegotiation Act, has been completely recast as a result of the turn of events of the past few weeks. It is now being rewritten while Congress is in a three-week Christmas recess and is almost entirely devoted to proposals contained in the Revenue Bill of 1943. This bill has run the gauntlet through the House. Just before the recess the Senate Finance Committee completed its hearings and made its recommendations. Thus, before the bill goes to the President for his signature, it remains to be passed by the Senate, the differences between House and Senate must be ironed out in conference, and the action of the conferees endorsed by both Houses.

No one had been so sanguine as to anticipate that renegotiation changes fully acceptable to the Price Adjustment Boards would glide smoothly through the halls of Congress. No statute in recent years has caused so violent an emotional explosion as has the Renegotiation Act. The bitterness and excoriation heaped on renegotiation has mounted steadily in intensity during the past year and the voices of opposition have found an increasingly sympathetic audience in a Congress in which the influence of the Administration has considerably waned.[1] The political swing to the right, foretold by all the omens, has increased the strength of the opposition.

On the other hand, it was not believed that the renegotiation statute would be so severely manhandled by this Congress. The overwhelming majority of the electorate stands firmly behind renegotiation. It is recognized as one of the strongest pillars of the Administration's procurement and economic stabilization program. A platform of taking the profits out of war is one that enjoys unassailable popular support. Reflecting that sentiment, it is inconceivable that Congress would vote to repeal the renegotiation statute in the face of irrefutable evidence that war contractors would reap unconscionable profits were it not for a method of subsequent recapture.

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[1] REPORT OF RENEGOTIATION OF WAR CONTRACTS, SEN. REP. No. 10, 78th Cong., 1st Sess. (1943) Part 5 (Truman Committee); *Hearings before Committee on Naval Affairs pursuant to H. Res. 30*, 78th Cong., 1st Sess. (1943); H. R. REP. No. 73, 78th Cong., 1st Sess. (1943) (Report of Committee on Naval Affairs); *Hearings before Committee on Ways and Means on H. R. 2324, 2698, and 3015*, 78th Cong., 1st Sess. (1943).

If renegotiation is to be retained, then logically the only changes that can be made, short of outright repeal, are procedural changes, designed to afford greater protection to the contractor, as by right of appeal. Renegotiation is fundamentally a bargaining process requiring the judgment and discretion of the renegotiators and that discretion cannot be readily fettered by a priori legislative commandments, unless the intent were clearly to shatter the operation of the law. During many closed sessions of the House Ways and Means Committee and the Senate Finance Committee, members of Congress groped vainly for a uniform formula to govern all renegotiation determinations, but finally had to admit that such an attempt to find a solution by formula was completely futile.

The changes proposed by the House Ways and Means Committee and passed by the House did not cut deep into the vitals of the Act. They consisted mostly of refinements in procedure, and gave a right of appeal; the only major change was a broadened exemption covering subcontracts for items which did not constitute a component part of the final military product. The Senate Finance Committee, however, ripped the statute apart and voted changes which would destroy renegotiation as we know it. Mandatory exemptions, principally for standard commercial products, would shrink renegotiation to less than two-thirds of its former size. The function of renegotiation as a pricing mechanism might be nullified by the duty imposed on the renegotiators to determine excessive profits after taxes. Renegotiation would not only be outlawed in future, but it would be declared illegitimate ab initio for certain items and contractors hitherto shorn of excessive profits totaling at least $500,000,000 for those items could claim restitution as if for illegal exactions for the sums repaid as excessive profits.

This is not reform—it is repeal. If 50% of the coverage by articles of renegotiation is cut away, that is 50% repeal. If 50% of excessive profits are declared immune from recapture, that, too, is 50% repeal. To label the changes recommended by the Senate Finance Committee as renegotiation revision is a misuse of terminology, a disguise to becloud the real issue, when the palpable effect is one of repeal. Members of the Senate Finance Committee during Committee hearings openly expressed their aversion to renegotiation as a whole. There is a well-informed belief that the Committee, cognizant of its inability to drive repeal through Congress, decided as an alternative on outright emasculation.

If the vitality of renegotiation is to be preserved, then the Senate version will have to be "toned down" to conform to the lines laid down by the House bill. The Administration will exert every influence toward that end, using the potent threat of veto. The testimony of industrialists favorable to renegotiation will be cited in its support. Among the enlightened business community there has developed a recognition that renegotiation repeal is unwise since it removes from the brow of business its wartime crown of thorns, its sole claim to martyrdom and equality of sacrifice. According to this view, it is wiser for industry to endure the travail of

renegotiation for a short period during the war than to carry for an indefinite post-war period the stigma of profiteering.

This article will discuss the changes proposed by the House and the Senate Finance Committee under three sections:

1. Limitations on the scope of renegotiation.
2. Substantive changes in the actual techniques of renegotiation.
3. Procedural and administrative changes.

NARROWING THE SCOPE OF RENEGOTIATION

Scope of Existing Renegotiation

Under existing law, contracts or subcontracts are subject to renegotiation if they satisfy these four tests:

(1) Do they cover goods other than raw materials, or raw materials in their first stage of processing? A contract or subcontract for the output of a mine, oil or gas well or other mineral or natural deposit, or timber is exempt from renegotiation provided the raw material has not been refined, processed or treated beyond the first form or state suitable for industrial use.

(2) Are the goods to be purchased ultimately by the War, Navy, Treasury Department, Maritime Commission or the Reconstruction Finance subsidiaries—Defense Plant Corporation, Metals Reserve Company, Defense Supplies Corporation, and Rubber Reserve Company?

(3) Are the aggregate sales to the Government, either directly or ultimately, in excess of $100,000?

(4) Was final payment made or is it to be made after April 28, 1942?

The Army, Navy, Maritime Commission, Reconstruction Finance Corporation, and Treasury are directed to insert renegotiation clauses only in contracts for an amount in excess of $100,000. However, contracts or subcontracts for these agencies are subject to renegotiation even without the existence of any renegotiation clause, unless they do not exceed in the aggregate $100,000 for the contractor's fiscal year. If the contractor's aggregate sales plus the aggregate sales of all persons under his control or under common control (i.e., subsidiaries) on contracts or subcontracts with the Army, Navy, Maritime Commission, R.F.C. and the Treasury do not exceed $100,000 for his fiscal year, he is then exempt from renegotiation.

These are the mandatory exemptions under the present Renegotiation Act. In addition, the Department head in his discretion may exempt from some or all of the provisions of the Act either individually or by classes or types the following contracts or subcontracts:

1. *Geographic limits*—Contracts or subcontracts to be performed outside of the territorial limits of the United States or in Alaska.

2. *Short-term contracts*—Contracts which can be performed within a period of thirty days.

3. *Stock items*—Where the actual costs are known and the profits can be determined with reasonable certainty at the time a firm price is set (as in the case of contracts for personal service, purchase of real property, perishable goods, commodities for which a minimum price has been set by a public regulatory body, leases and license agreements, etc.).

4. *Other protection against excessive profits*—Contracts providing for revision of prices on the basis of experience, and contracts providing for sharing of reduction of costs between the Government and the contractor, are examples. Such contracts include those which provide for forward pricing. It would also cover cost-plus-fixed-fee contracts and those lump-sum contracts which contain price redetermination provisions requiring a price adjustment by formula.

Virtually every subcontract and sub-subcontract is subject to renegotiation. Every tier of subcontractors, no matter how far removed from the prime contractor, can be reached. Subcontracts are broadly defined to include any purchase order or agreement to perform all or any part of the work or to make any article required for the performance of another contract or subcontract. Thus, the term includes any services and articles supplied, including "any materials, part, assembly, machinery, property, or other personal property." It includes catalysts, lubricating oils, abrasives, and similar supplies. It includes even small supply contracts for less than $1,000 if the seller's sales for use on Government contracts aggregate $100,000. Contracts for machine tools and similar capital equipment are subject to renegotiation.

Raising the Floor to $500,000

Both the House and the Senate Finance Committee have recommended an amendment exempting specifically from the Renegotiation Act all contractors and subcontractors whose renegotiable sales are under $500,000 a year—at the present time the ceiling is $100,000 a year. The War and Navy Departments have endorsed this proposal.

This amendment, if passed, will not mean that a single contract standing by itself of less than $500,000 will be exempted from renegotiation; all contracts or subcontracts held by a single contractor are added in the aggregate to determine whether they come within the exemption.

Under the present law, the Army, Navy, Maritime Commission, and Treasury are directed to insert renegotiation clauses only in contracts for an amount in excess of $100,000. However, contracts or subcontracts for these agencies are subject to renegotiation even without the existence of any renegotiation clause if they exceed in the aggregate $100,000 for the contractor's fiscal year. The contracts and subcontracts are added up on a horizontal basis. Thus a company may be a prime contractor at $75,000, a subcontractor at $15,000, and a sub-subcontractor at $20,000. Since the total of the Government contracts and subcontracts held by the individual total more than $100,000, all these contracts are subject to renegotiation even in the absence of a renegotiation clause.

There are two arguments advanced in favor of the exemption.[2] In the first place, it would greatly reduce the administrative load since it is estimated that 17% of all contractors now subject to renegotiation would be excluded. In the second place, renegotiation works a particular hardship on small businesses which are not readily able to bear the burden of renegotiation. Companies with dealings of $10,000 a week or so generally do not have accounting and legal staffs of any size set up; consequently, segregation of renegotiable sales and costs of their sales cannot be readily checked. On the negative side of the proposal, however, it has been pointed out that small contractors might deliberately turn down a contract which would carry them over the $500,000 mark and thus expose their profit picture to surveillance with a view to possible recapture. Again, the exemption, if enacted, might work an unfair discrimination against the large contractor since inordinately large profits may just as readily result from small contracts as from large ones.[3]

[2] In favor of the exemption, see the testimony of Under Secretary of War Patterson, *Hearings before Committee on Ways and Means, supra* note 1, at 798 (Part 9). Against the exemptions, see H. R. REP. No. 733, *supra* note 1, at 12.

[3] Another approach to the setting of a higher floor for renegotiation has been advanced in a bill (S. 1366, 78th Cong., 1st Sess. 1943) introduced by Senator Hatch, Chairman of the Truman Committee which investigated renegotiation some months ago, which adds an exemption by formula to the present exemptions. To qualify for this flexible exemption, a contractor must meet two tests: (a) His profits before deduction of Federal income and profit taxes must not exceed 8% of his total sales; and (b) his total sales must not be more than three times his average total sales during the base years 1936 to 1939 inclusive. While recognizing that no exact formula for computing the proper amount of renegotiation refunds is equitable or possible, Senator Hatch argues that experience shows that such an exemption formula will expedite renegotiation and at the same time free businessmen from much existing uncertainty in formulating business policies and plans. The formula is based on the experience of the past year and a half. The 8% minimum profit was selected since the profit realized after renegotiation generally has exceeded this figure. Similarly, the "three times average base period sales" exception covers most of the cases in which profits were renegotiated to a figure below 8%.

An analysis was made of the 683 War Department cases cleared prior to July 29, 1943, without recapture of any excessive profit. Four hundred and sixty-nine of the 683 cases involve profits of 8% or less on all sales, including non-renegotiable as well as renegotiable sales. Three hundred and thirteen of these cases likewise would have met the "three times average base sales" test so that under the formula almost half of this "non-recapture" group of contractors could have determined this fact in advance. At the same time, an analysis of more than 3,000 War Department cases in which recaptures were effected was prepared which shows that only in 163 of these were the contractors left after renegotiation with less than an 8% profit on total sales. Only 30 of these 163 cases would have avoided renegotiation by reason of total sales being less than triple the average realized during the base years and all of these 30 were small contractors. The total recovery from all 30 was $847,500 and the maximum from any one $90,000. According to Senator Hatch, 75% of the $847,500 would have been recovered under the Excess Profits Tax Law, but the Army Price Adjustment Board estimates this figure at between 60% and 70%.

Contractors who have started business since 1936 will find the profit exemption of little benefit. If they commenced business after December 31, 1938, they are not entitled to the exemption. Although entitled to the exemption, moreover, contractors and subcontractors who began business between December 31, 1935, and January 1, 1939, probably in the vast majority of cases will not come within the exemption since the base period is from the date business was actually commenced to December 31, 1939. A new business takes time to get rolling and even in a normal market a substantial yearly increase in sales could be expected.

Under the Hatch Bill, no change is made in the present exemption extended to contractors whose prime and subcontracts aggregate less than $100,000, for the fiscal year. The 8% profit exemption is superimposed over this. In other words, there would be two exemptions: (1) Contractors with aggregate sales of less than $100,000 for the fiscal period; and (2) contractors with profits of 8% or less

Exemption for Standard Commercial Articles

The House passed a provision granting discretionary authority to the War Contracts Price Adjustment Board, a new Board set up under the 1943 Act to exempt from renegotiation standard commercial articles, if, in its opinion, normal competitive conditions existed affecting the sale of such articles. This was a weak compromise on this controversial proposal since the Price Adjustment Boards, standing in firm opposition to such an exemption, would rarely, if ever, choose to exercise the privilege. The Senate Finance Committee, however, has recommended that the exemption be made absolutely mandatory on the Boards, thereby reducing the orbit of renegotiation by at least a third.

The term "standard commercial article" is defined in this manner under the House bill:

"(A) Which is not specially made to specifications furnished by a Department or by another contractor or subcontractor,

"(B) Which is identical in every material respect with an article which was manufactured and sold, and in general civilian, industrial, or commercial use prior to January 1, 1940.

"(C) Which is identical in every material respect with an article which is manufactured and sold, as a competitive product, by more than one manufacturer, or which is an article of the same kind and having the same use or uses as an article manufactured and sold, as a competitive product, by more than one manufacturer, and

"(D) For which a maximum price has been established and is in effect under the Emergency Price Control Act of 1942, as amended, or under the Act of October 2, 1942, entitled 'An Act to amend the Emergency Price Control Act of 1942, to aid in preventing inflation, and for other purposes,' or which is sold at a price not in excess of the January 1, 1941, selling price. An article made in whole or in part of substitute materials but otherwise identical in every material respect with the article with which it is compared under subparagraphs (B) and (C) shall be considered as identical in every material respect with such article with which it is so compared."

The Senate definition struck out paragraph (A) so that an article especially made to specifications of the contracting department would nonetheless be considered as a standard commercial article.

The range of commodities encompassed within the definition is not too definite. It would clearly cover manufactured textiles, lumber, shoes, operating tables, sterilizers, artificial teeth, X-ray equipment, etc., which are in general civilian use. It

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whose sales are less than triple the average base period sales. If Congress sees fit, the provisions of the Army-Navy sponsored bill—H. R. 2324—raising the $100,000 exemption figure to $500,000 can be written into the Hatch Bill.

might also apply to many tools, most plates, shapes and forms, many engines, welding equipment, and thousands of the component parts like bearings and nuts which go into finished war products. For example, a motor in a jeep may very well be a standard commercial product to the same extent as a toothbrush.

Two reasons are given by the advocates of a provision to grant mandatory exemption for all standard commercial articles:

1. Costs of such standardized articles are so well known that contracting officers are able to work out contract prices which avoid excess profits. These articles were produced long before the war and peacetime competition compelled standardization of production costs.

2. OPA price ceilings which are imposed on such commercial articles are sufficient to prevent a contractor from reaping undue profits.

Opponents of the amendment are quick to make the rebuttal. In reply to the first point, they state that the huge volume of production necessitated by war demands has tobogganed unit costs so that production costs now bear little resemblance to what they were before the war. With shifting labor and material costs, amid all the uncertainties of war production, a contracting officer cannot predict with any certainty what unit production costs are going to be for standard commercial articles based on the arithmetic used in the past history of the firm.

In answer to the second point, the Government spokesmen point to the fact that the OPA price ceiling is ineffective to limit the huge profits of the low-cost, efficient producer. Under the bulk-line principle of pricing, which was used in the last war and is the approach applicable today, the ceiling is placed at the level of the highest cost marginal producer whose output is necessary to maintain the minimum war or essential civilian supplies. As unit costs drop, the producer obtains a windfall profit as the ceiling stays intact—in the absence of a differential pricing method the price ceiling actually guarantees a return, dollar for dollar, for any reduction in production costs, dependent or independent of the contractor's efforts.

The price ceiling sets the maximum for which the producer can sell the commodity. The OPA advises him that he is permitted to sell below the ceiling, but this encouragement is thrown to the wind. In a seller's market, few producers will sell below the ceiling price. In a peacetime market with competition the price is driven close to cost. In a wartime market, any resemblance between the ceiling price and the cost to the producer selling within the ceiling is purely coincidental.

The following figures show the excessive profits which have been realized in certain standard goods industries. These companies, it should be noted, are engaged principally in subcontracting and are substantially all of those in these classifications which have been renegotiated by the War Department. These cases represent what has happened in standard product businesses as a result of the war and are examples of the profit results of volume increases before taxes.

[000 omitted]

	1942	Average 1936-39	Increase	Percent increase
Perishable tools, 19 companies:				
Sales	$172,011	$29,418	$142,593	485
Profit before renegotiation and taxes	$62,010	$5,025	$59,985	1,134
Percent profit	40.0	17.1	22.9	128
Woolen textiles, 25 companies:				
Sales	$237,782	$98,030	$139,752	143
Profit before renegotiation and taxes	$31,985	$3,245	$28,740	885
Percent profit	13.5	3.5	10.2	309
Lumber, 10 companies:				
Sales	$106,677	$42,228	$64,449	153
Profit before renegotiation and taxes	$25,908	$4,991	$20,917	419
Percent profit	26.1	11.8	14.3	121
Cotton textiles, 53 companies:				
Sales	$548,633	$207,185	$341,448	165
Profit before renegotiation and taxes	$76,209	$8,467	$67,742	800
Percent profit	13.9	4.1	9.8	239

As a specific example, one company, and not by any means the most unusual, did an average volume of business from, 1936 to 1939, of $16,500,000. It earned an average dollar profit, before income taxes, of $1,220,000, at the rate of 7.4 percent on sales. In 1942, its sales were nearly $50,000,000, its profit before tax $12,500,000, and its earning rate 25 percent on sales. It would be difficult to conclude that this manufacturer of a standard product under Office of Price Administration price ceilings was not benefiting from the war to an unreasonable degree.

Under the Renegotiation Act, the Secretaries of the Army, Navy, Treasury, or the Chairman of the Maritime Commission have full discretion to exempt contracts for stock items where the actual costs are known and the profits can be determined with reasonable certainty at the time a firm's price is set. Exemptions have been allowed for contracts for perishable goods and for certain contracts and subcontracts with public utilities and common carriers. Price Adjustment Boards have indicated their complete willingness to extend this exemption to any production where, on the basis of the facts presented, it seems administratively wise. However, they resist any blanket exemption beforehand by statute. Such a procedure would open the door to a competition between various industries to put the most political pressure on Congress to include them within the exemption and would be like a tariff logrolling contest all over again.

Note the fact that under this provision for exemptions within the discretion of the Secretaries of the various departments, the forward pricing method has been adopted. A contractor who wishes to get a fixed price for future deliveries not subject to renegotiation and who can establish his costs with reasonable certainty can obtain the dispensation of forward pricing free from renegotiation. Producers of standard commercial articles can take advantage of this opportunity. The contractor must, however, fix his price on a comparatively narrow margin of profit,

because, based upon his own statement, his costs are definite and his risks are therefore negligible.

Exemption for Subcontracts for Non-Component Parts

The House bill narrowed the scope of the present Act by eliminating from renegotiation auxiliary contracts, that is, contracts for articles or services not going into an end product or a component thereof. This change was accomplished by defining subcontract in Subsection (a)(5)(A) as follows: "Any purchase order or agreement (other than a contract with a department) to make or furnish or to perform any part of the work required for the making or furnishing of a contract item or a component article." The bill then defined a component article as: "Any article which is to be incorporated in or as a part of a contract item." Under the House bill, this change was confined to fiscal years closing after June 30, 1943. The Finance Committee bill, however, made this provision retroactive to April 28, 1942, annihilating the effect of the law altogether for these articles. This would require refunds totaling over $500,000,000 to industries such as machine tools, factory and mill supplies, construction equipment, cranes, hoists, and other industries operating under contracts or subcontracts for auxiliary articles.

In a limited study of 60 relatively small subcontracts, the Army Price Adjustment Board estimated that $72,883,000 of recoveries would have to be refunded, re-establishing margins of profit ranging all the way from 17.7 cents on each dollar of sales to 54.2 cents on each dollar of sales. After giving effect to taxes, net refunds to these subcontractors would amount to $13,228,000. None of these companies is very large. It has not been determined what would have to be refunded to subcontractors such as General Electric, Western Electric, General Motors and other large subcontractors.

Additional Exemptions Under the Bill

1. *Agricultural Commodities.* The House bill made mandatory an exemption for agricultural commodities on the same basis as the previous exemption for raw materials. The exemption reads as follows: "Any contract or subcontract for an agricultural commodity in its raw or natural state, or if the commodity is not customarily sold or has not an established market in its raw or natural state, in the first form or state, beyond the raw or natural state, in the first it is customarily sold or in which it has an established market, or any contract or subcontract for canned, bottled, or packed fruits or vegetables (or their juices) which are customarily canned, bottled, or packed in the season in which they are harvested. The term 'agricultural commodity' as used herein shall include but shall not be limited to—

"(i) Commodities resulting from the cultivation of the soil such as grains of all kinds, fruits, nuts, vegetables, hay, straw, cotton, tobacco, sugar cane, and sugar beets;

"(ii) Saps and gums of trees;

"(iii) Animals such as cattle, hogs, poultry, and sheep, fish and other marine life, and the produce of live animals, such as wool, eggs, milk and cream."

The Finance Committee continued the House exemption of agricultural commodities, but added to the list of such commodities as contained in the House bill: "Any contract or subcontract for a canned, bottled, packed, or processed dairy product or any product, the principal ingredient of which is a dairy product."

The Price Adjustment Boards are opposed to the exemption for seasonal canned, bottled or packed fruits and vegetables and for dairy products. However, the exemptions as a whole give legislative ratification to the present practice of Price Adjustment Boards which have issued a long list of exempt agricultural products. In granting such exemptions, the Boards acted on highly tenuous grounds. Although they assumed to act under the provision authorizing the Secretary to exempt contracts where the profit was definitely determinable in advance, it was doubtful that their action fell technically within the statutory provisions. In view of the fact that the legislative exemption follows closely the administrative practice, the Departments recommended that the exemption be made retroactive to April 28, 1942, and this suggestion was adopted in the bill.

2. *Charitable Institutions.* The House and Senate bills exempted any contract or subcontract with an organization exempted from taxation under Section 101(6) of the Internal Revenue Code. The Departments have recommended that this exemption be made retroactive and the bills so provide.

3. *Public Utilities.* The Finance Committee bill exempts from renegotiation, effective for fiscal years closing after June 30, 1943, contracts or subcontracts with a public utility to furnish gas or electric energy or with a common carrier to furnish transportation, when made at published rates or changes fixed or approved by a public regulatory body. This provision is in accord with present practice of the Boards.

4. *Construction Contracts.* The Finance bill exempts contracts with a Department, awarded as a result of competitive bidding, for the construction of any building, structure, improvement or facility.

5. *Production Directives.* The Finance bill exempts any contract or subcontract for an article made or furnished in obedience to a directive of the War Production Board at or below ceiling prices. This provision is made retroactive to April 28, 1942.

6. *Exempted Contracts.* Any subcontractor directly or indirectly under a contract or subcontract which is exempted from renegotiation by virtue of the Act is also made exempted.[4]

[4] Present bills do nothing to enlarge the areas of renegotiation despite some pressure to encompass a greater area within the renegotiation framework. The largest of these areas is the purchasing activities of the Department of Agriculture. Its contracts between March 12, 1941, and March 31, 1943, amounted to $1,661,318,152.32. To some of its purchases, such as its parity, soil conservation and subsidy programs, renegotiation cannot be applied. On the other hand, renegotiation would be readily applicable to purchases of commodities like dehydrated foods, dried eggs, concentrated citrus juices, meats and other commodities. In many of these contracts, the Government has built facilities for the contractor, the

SUBSTANTIVE CHANGES IN RENEGOTIATION

Standards in Determining Excessive Profits

The new Renegotiation Act will set forth the standards which are to guide the Price Adjustment Boards in determining excessive profits. The House bill contains the following standards:

1. Efficiency of the contractor, with particular regard to the attainment of quantity and quality production, reduction of costs, and economy in the use of raw materials, facilities and manpower.

2. Reasonableness of costs and profits, with special regard to the volume of production and to normal pre-war earnings.

3. The amount and source of public and private capital employed, and the net worth.

4. The extent of the risk assumed, including the risk incident to reasonable pricing policies.

5. The nature and extent of the contractor's contribution to the war effort, including contributions and cooperation with the Federal Government and with other contractors in supplying technical assistance.

6. The character of the business including the complexity of manufacturing technique, the number and extent of subcontractors, the rate of turnover, and the potential financial burden to reconvert to peacetime production.

The Senate bill changed the second standard to read as follows: "Reasonableness of cost and profits with particular regard to volume of production and normal pre-war earnings and comparison of war and peacetime products." This change

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costs of operation were unknown as the contracts were entered into, and in the execution of the contract became later ascertainable. According to the Vinson Bill, the Secretary of Agriculture would be specifically authorized to renegotiate such contracts. In determining the existence of excessive profits, however, he will not act where the determination would conflict with the purpose of any program or regulation relating to prices of agricultural commodities or commodities processed in whole or in part from them.

The House Naval Affairs Committee has recommended that the Act be broadened to cover Lend-Lease contracts, since a survey made by the Committee discloses that large profits—in some cases as much as 100% in relation to cost—were made by American contractors on these contracts. Many of these contracts are on the same footing as domestic contracts since the "take-over" agreements entered into between the War Department and the British and Netherlands Governments at the start of the war provided for a purchase by the United States from the foreign governments of the articles covered by the contracts at the prices fixed by contracts which those governments had with American contractors.

The Committee also favors the renegotiation of all contracts made by Government agencies, even though not specifically covered by the Act, if the head of any department believes that a contract made by that department will yield excessive profits, the task of renegotiation will be assigned to the Secretary of the Treasury in the same manner and with the same authority as if the contract had been entered into with the Treasury. Thus, contracts let by the central administrative services of the Office of Emergency Management, the Office of War Information, National Housing Agency, the Office of Economic Warfare and the Office of Strategic Services would be included within the Act. However, to avoid confusion if each of these agencies were permitted to carry on renegotiation, the task would be entrusted to Treasury. This provision is included in the pending Vinson Bill. The House Naval Affairs Committee additionally has recommended that the Renegotiation Act be clarified so as to indicate its applicability to all contracts entered into by the Treasury Department and not merely those for Lend-Lease account. The General Counsel of the Treasury Department has administratively removed from renegotiation purchases made by Procurement Division of Treasury for other agencies such as War Production Board, War Manpower Commission, Office of Price Administration, etc.

was made at the request of the Price Adjustment Boards. It would enable the Boards to hold down profits to the same comparative level as during peacetime. However, it would not bind the Boards to use peacetime profits as a guide for a firm whose production had radically changed so that its peacetime and wartime production are in no way comparable. Additionally, it emphasizes the fact that a contractor is entitled to a higher profit rate if he has converted peacetime machinery to turn out war goods for the Government. Contractors who use converted machines are apt to incur higher costs, produce at a slower rate, turn out poorer quality and use more materials. If these adverse factors can be explained by cooperation with the Government objective to make full use of existing equipment, Price Adjustment Boards will make a suitable extra allowance to the contractor to compensate for the disadvantages he has suffered in converting to war production.

The Senate Finance Committee also added two standards which are discussed immediately below.

Determination of Excessive Profits After Taxes

In renegotiation the profit allowed is a profit before taxes rather than after taxes. Price Adjustment Boards will not adjust profits upwards to take care of war taxes. If, however, the weight of taxes would practically wipe out profits, or leave inadequate funds to meet working capital needs, or obligations falling due, some consideration may be given to the profits-after-taxes picture. It is worthwhile for a contractor to bring it up in a renegotiation proceedings although it is doubtful that it will be any substantial kind of a determining factor. It is, however, the policy of the Price Adjustment Boards to scrutinize the position of the contractor after taxes in order to provide where necessary reasonably deferred installment payments to reduce the burden of the contractor in satisfying the obligation imposed by renegotiation.

There has been tremendous pressure from industry to swing over from the criterion "before taxes" to that of profits "after taxes" as a basis of determining excessiveness of profits in war business. The Disney Subcommittee of the Ways and Means Committee recommended to the full Committee a provision that Price Adjustment officials be instructed to consider the effect of renegotiations on profits after taxes. However, the full Committee voted against this proposal thus approving the position of the Price Adjustment Boards that excessive profits are to be determined without regard to the taxes that are payable with respect to those profits.

The Senate Finance Committee reversed the picture. It added a clause that in determining excessive profits, the Price Adjustment Boards shall take into consideration: "Whether the profits remaining after the payment of estimated Federal income and excess profits taxes will be excessive."

A genuine after-taxes basis would operate by allowing taxes as a full-fledged cost item. The Price Adjustment Boards would first set a figure representing a fair

profit allowance by the general approach in which the starting point is a comparison of percentage of net sales during the renegotiated year and the percentage of sales during the base period 1936 to 1940. Various modifications and variables would then be employed either to increase or decrease the profit allowance or as a check on reasonableness. After arriving at this figure, the Boards, on an after-taxes approach, would allow a sufficient amount to that after Federal taxes are paid, the contractor would be left with the profit allowance completely free and clear of the tax burden. Thus, if the Board determined that a firm making $100,000 profit for the year was entitled to a reasonable profit of only $20,000, it might allow as profit $50,000 if the firm had to pay out 60% of the $50,000 in taxes. Thus, the difference representing the excessive profits on a before-taxes approach would be $80,000, but on an after-taxes approach would be only $50,000. The renegotiators on that basis would be paying out $30,000 to the contractor as a cost item to balance out his taxes. If another contractor had a heavier tax rate, and required $60,000 in order to have $20,000 free of taxes, the Board in that case would be paying out $40,000 to the second contractor. The Price Adjustment Boards would obviously be equalizing the tax burden as between different contractors by allowing as a cost a larger amount to the firm paying the larger tax.

If the Finance Committee had intended that taxes should be treated as a cost item or that profits should be calculated free and clear of taxes, that intent could have been clearly effectuated by an explicit statement to that effect. On the contrary, however, it was not so stated, but it was merely listed as one of the standards to guide the Boards in determining excessive profits. These standards are used as compensatory factors to inflate or deflate a basic preliminary figure which is arrived at by comparison of percentage of net sales in the pre-war and war years. It is impossible to treat the after-taxes instruction in the way it is phrased as a factor only to be used to increase the basic figure in the same way as efficiency of the contractor, extent of his risk, his contribution to the war effort, etc. If the approach were definitely that taxes were to be treated as a cost, a firm earning $50,000 if it had to pay $30,000 out in taxes could not be renegotiated further if $20,000 were a sum commensurate with a fair profit allowance. On the other hand, if the after-taxes rule is to be treated merely as a guide affecting the final profit allowance, the Price Adjustment Board would be free to treat a figure around $20,000 as a reasonable profit margin, and then increase that figure because of the taxes that the contractor must pay. However, it is difficult to see any justification for increasing the $20,000 for taxes other than to pay the taxes on the $50,000. This would put the Board back to a thorough after-taxes basis. Thus, despite the fact that the after-taxes provision is stated merely as a guide to the Boards, it seems inconsistent with any position other than as a prime determinant as to whether any excessive profit remains for renegotiation, and if it does, then a mandatory requirement that a sufficient allowance be added to the reasonable profit so that the contractor can receive it in full without further deductions.

Industry states its case for the use of the "after taxes" standard in this way: Businessmen never think of profits before taxes; profit to a businessman is net realization—it is not net profit or profit after taxes, since taxes are regarded like wages or material costs as part of the expense of doing business. When the Government determines that a sum is proper as a profit allowance, and uses a sum before taxes, it is using a figure which is completely arbitrary and fictitious. Businessmen complain that any survey of earnings figures will show a dip in 1942 below 1941 and there will probably be an even greater dip for 1943 because of the increase in tax rates. They claim that they are working longer and harder and netting less because of the failure of the Price Adjustment Boards to consider the "after taxes" picture, thus helping to promote a gross inequity.

To the plea of industry, Price Adjustment officials turn a deaf ear and present an imposing array of arguments in defense of their position:

1. If it were true that contractors are realizing a net profit less than in 1941 or even in a year prior to 1941, they would have no legitimate complaint. The loss of the right of making money is comparatively a slight sacrifice to ask of a citizen in wartime. If profit were calculated after taxes, business would in effect receive special treatment since it would be exempted from the added burden that each taxpayer must absorb in wartime. Business in effect would be given a bonus in order to pay taxes.

2. Renegotiation after taxes would hamper the functioning of Price Adjustment Boards as part of the procurement agencies. It is the duty of the Boards to reduce contract prices to amounts which are reasonable; the reasonableness of a contract price does not depend upon the amount of taxes the contractor must pay.

In his testimony before the Ways and Means Committee Under Secretary of War Patterson gave a graphic illustration to show how calculation of profits after taxes would render the renegotiation process impotent in many cases. Suppose there are two contractors, A and B, each making the same article, for example a rifle sold to the Government at a price of $100 per rifle, and each contractor having the same unit costs with the single exception of Federal taxes. Assume that the costs before taxes in each case amounted to $70 per rifle but that in the case of Contractor A the Federal taxes on the $30 profit realized on each rifle amounted to $12 and that in the case of Contractor B the Federal taxes amounted to $24.

Under the present practice, assuming that a 15 per cent margin over cost represented a reasonable profit, both Contractor A and Contractor B would be allowed a profit before taxes of approximately $10 and would be required to reduce their prices of future deliveries to approximately $80 per rifle. On the other hand, if renegotiation were to be based upon profit remaining after taxes and an equal amount should be left to each contractor, if Contractor A were to be given a price of $80, leaving him a profit of approximately $10 before taxes and $6 after taxes, it would be necessary to allow Contractor B to continue his present price of $100,

giving him a profit before taxes of $30 and a profit after taxes of $6, the same as that received by Contractor A.

3. The Price Adjustment Boards in an "after taxes" basis would become tax boards. A switch to an "after taxes" basis would involve the juggling of tax rates and the equalization of taxes between contractors. This is the function of Congress and not the Price Adjustment Boards. Such a procedure would result in having the Government pay the contractors' wartime income taxes and would relieve them from the additional taxes which Congress has imposed on them. The Government would thus be chasing itself around the circle.

4. The effect of an "after taxes" basis would vitiate the will of Congress as expressed in the excess profits tax with respect to the varying impact of tax rates on taxpayers entitled to different excess profits credits. Congress proclaimed the policy of considering excess profits before taxes by the terms of the Revenue Bill of 1941 which changed the prior tax law allowing the income tax as a deduction in computing the excess profits tax. The Committee on Ways and Means at the House in its report on the bill stated: "It seems unfair to allow that part of the income tax which is computed on income which is not subject to the excess profits tax to reduce the excess profits net income. This Committee has therefore deemed it advisable to return to the 1918 ruling and has disallowed the deduction of income taxes both in the base period and in the taxable year in computing the excess profits tax.

The varying tax bases under the Excess Profits Tax have been one of the chief spurs to the movement to base renegotiation after taxes. On that approach, the Price Adjustment Boards would be equalizing the tax law by making a greater allowance to the firm which has to pay the greater tax. Renegotiation would thus be partial to firms which are handicapped under the tax law. A corporation with a small amount of invested capital and smaller earnings in the base years pays a higher tax on the same amount of profit than does a corporation which in its base years had a larger amount of invested capital and earnings. Thus aircraft companies which were not mass producers and had little invested capital and earnings in the pre-war years get a smaller profit per plane than do the established companies with a more favorable tax base. However, this is exactly what the Revenue Act intended, since Congress wanted to put a higher tax on profits which were the outgrowth of war production.

Maurice Karker, Chairman of the War Department Price Adjustment Board, explained how the "after taxes" approach would hamper the operation of the excess profits tax: "Federal taxes, and particularly the excess profits tax, have peculiarities derived at least in part from the alternative basis allowed for figuring the amount of the tax. The tax currently paid by a corporation is dependent not only on its earnings for its current year, but substantially upon its earnings during its base years or upon its invested capital. Its current tax may likewise be substantially modified or entirely eliminated by loss carry-over from a prior year. Changes in

ownership or management or increased efficiencies with present outstanding contribution to the war effort, might, nevertheless, if renegotiation considered earnings after taxes, fail to receive comparative reward in renegotiation as against a company with a high earnings record and present inefficiencies. A company which manufactured a patented product or an item made under a secret process or otherwise produced under a peacetime monopoly, with resultant extreme profits during the past years, would be allowed inordinate profits on production for war, even though the nature of its present production might be entirely different from its peacetime production and even though extravagance and waste mark its current operations. The inequalities and inequities of pricing, whether initially or in renegotiation, based upon the taxes paid by the contractor, thus are obvious."

5. It is recognized that use of the "before taxes" method is a valuable aid in curbing inflation. If a contractor can raise his price to cover increased taxes it is as if Congress with its right hand were setting up a pricing and procurement agency and at the same time with its left hand establishing a tax law which operates to counteract or nullify the purpose of the price and procurement agency. Following this principle, OPA has consistently followed a "before taxes" rather than "after taxes" approach in setting industrywide ceilings and similarly has refused to countenance an individual price increase in order to offset the heavy tax burden.

6. The "after taxes" approach would make it impossible to carry on renegotiation because the correct tax for the fiscal year involved may not be known for some time. Thus the excess profits tax law has carry-back provisions, general relief provisions, inventory adjustment provisions, and the provisions allowing revision of tax returns on termination of the war for the purpose of modifying the amortization allowance under Certificates of Necessity. Because of these provisions, the true excess profits tax may not be known for several years. Additionally, even if they were definitely known at the end of the year, it would be impossible for the price adjustment official to carry on the forward-pricing method under the statute.

A more complicated question arises in connection with the recognition of the effect of state taxes on renegotiated profits. The question is whether the renegotiation boards should give a credit for the amount of state taxes paid on profits which have been shaved off on its review. The policy of the boards is to allow full credit for state taxes only where the state will not make a refund after renegotiation; in all cases an actual credit is given to the contractor but where it is possible under state law to obtain a refund from the state treasury, the renegotiation agreement will contain a provision that the contractor must apply within ten days and then turn the refund back to the Federal Government. This practice is opposed by the National Association of State Tax Administrators which has petitioned Congress to set up a uniform procedure. There is a lack of uniformity in the practice of various states. Arkansas does not permit a refund of corporate taxes and therefore the full amount paid is treated by renegotiation officials as a non-

recoverable expense. New York, however, permits refunds to be claimed within a reasonable period. Connecticut allows refunds resulting from renegotiation to be claimed if the contractor cannot secure credit from the Federal Government for the taxes. Thus in no case is the burden put upon the contractor but it operates harshly, it is claimed, on states like New York in which taxes have frequently been spent, since the state acts as a collection agency for local communities and distributes a substantial portion of its corporate taxes to these communities upon collection. The difficulty and costliness of making refunds threatened to induce all states to protect themselves by provisions refusing refunds.

It has been proposed by the National Association of State Tax Administrators that the states be required to make refunds only for "current" renegotiation not for "retroactive" renegotiation. Thus renegotiation affecting profits for 1943 completed before December 31, 1943, should be given effect by the states; but if 1943 profits are adjusted after that date renegotiation should give the contractor full credit for state taxes paid or accrued on the basis of 1943 income before renegotiation. The price adjustment officials oppose such a change on the ground that it would amount to a subsidy. State governments can make a rough prediction in advance as to the inroads on income that will be made by renegotiation—they can be guided to some extent by revenues of pre-war years. Moreover, a method can be adopted for the settlement of accounts between the state and local governments to facilitate refunds where necessary.

The new bill as approved by the House and by the Senate Finance Committee provides: ". . . but in determining the amount of excessive profits to be eliminated, proper adjustment shall be made on account of the taxes so excluded other than Federal taxes which are attributable to the portion of the profits which are not excessive." Thus the Price Adjustment Boards would apply a uniform procedure in the case of all state taxes, whether or not the state makes refunds, where profits have been reduced by renegotiation. Credit would no longer be allowed for state taxes paid on profits recaptured as excessive, but the burden would be on the contractor to get his own refund. The Treasury Department claimed in Committee hearings that in 43 or 44 states there are no state taxes on corporate income, or the state law affirmatively provides that state taxes will be levied on income as adjusted in renegotiation; or the law is reasonably clear that the result will be the same. A consistent position that the renegotiators will recognize taxes only on adjusted income will put pressure on all states to adopt a uniform practice of granting refunds.

Recognition of Reconversion Costs in Renegotiation

The Senate Finance bill provides that in determining excessive profits the Price Adjustment Boards shall take into consideration the financial provisions of reconversion. Again, as in the case of provision for consideration of profits after taxes, the meaning of this provision is ambiguous. The renegotiators are enjoined to give

consideration to financial problems of reconversion, but the factors of reconversion are not stated nor does the provision indicate how much weight should be given to reconversion problems. The inclusion of the provision as merely one of the standards to guide determination of excessive profits makes it an elastic and flexible guide. The Price Adjustment Boards are by no means bound to recognize post-war reconversion *reserves* as costs. They may increase the profit allowance to a firm in recognition of its physical reconversion prospect because the firm has no other resources with which to undertake reconversion. On the other hand, the Renegotiation Board might determine that adequate relief is given by the carry-back provisions of the Excess Profits Tax or by the 10% post-war refund. It may decide that adequate reserves have already been set up by the contractor which will be sufficient to meet his future working needs. It may decide that capital needs can be adequately met in the future by floating securities in the private market.

The Board may confine its concept of reconversion to an actual physical change-over. According to answers filed with the National Industrial Conference Board, only four out of every ten firms engaged in war production plan a complete conversion of all of their present capacity to peacetime production. Between two and three companies need no reconversion, since their war and peace products are identical. The remaining three or four companies out of every ten plan partial conversion, but apparently only about one-sixth of this number expect to convert more than a half of their existing capacity. Sumner Slichter has estimated that the actual cost of physical change-over will be less than $500,000,000. Physical reconversion of itself the Boards may not find a tremendous financial problem.

There is universal agreement that many industries will have to cope with great financial burdens in reconverting to peacetime demands that will put a strain on their working capital. Some plants will have to be re-equipped to switch from wartime to peacetime production; machinery which has undergone accelerated depreciation due to intensive war use will have to be replaced—and even if the machinery is in good condition, it may have to be replaced to take advantage of radical improvements developed during the war. Maintenance and repairs, delayed due to production pressure, will have to be made at a greater expense. Inventory losses will be heavy. Lost markets and distribution channels will have to be recaptured, sometimes in the face of new competition attributable to the Government's entering the field during the war or subsidizing new competitors. Added on to all of these burdens will be the duty, legal or moral, of making separation or severance pay allowances to employees no longer needed.

Although there is agreement on the peril that these charges entail to financial solvency after the war, the difference of opinion arises as to the proper method of meeting the problem now, well in advance of the emergency. Specifically, the question boils down to whether financial reserves created out of profits for meeting post-war contingencies should be recognized as proper deductions for tax pur-

poses, and as a corollary position should be recognized as a proper and legitimate item of cost in renegotiation.

The first problem is one for the Treasury. The second is one for the Price Adjustment Boards. The answer of both agencies to a recognition of these items during the war years is a flat "No!"

The link between the decisions of the Treasury and Price Adjustment officials is more than accidental. The Renegotiation Statute provides that Price Adjustment officials ". . . shall recognize the properly applicable exclusions and deductions of the character allowed under Chapter 1 and Chapter 2E of the Internal Revenue Code." Price Adjustment Boards have construed this to mean that they are bound to recognize "exclusions and deductions" of the same type as allowed by the Treasury though not necessarily the same amount. However, since the Treasury does not recognize post-war contingencies in any amount, similarly, Price Adjustment Boards are free from any legal obligation to take such reserves into account.

Since the policy of the Price Adjustment Boards is contingent on the definition of Treasury policy, the statement of Randolph Paul concerning Treasury policy toward post-war reserves on October 21 before the American Institute of Accountants is significant. Paul stated that the carry-back provisions of the 1942 Revenue Act, representing a potential reserve of 100% of two years' income, provides a simple technique of charging post-war costs to wartime income. The reserve technique requires anticipation of the cost of reconversion at a date no one now knows and of an amount that no one now can possibly guess. Thus the amount of any reserve established at this time would have to be set at an arbitrary figure. Under the carry-back technique, however, the costs are calculated at a time when they are known or can be definitely ascertained. When the cost of reconversion occurs, the taxpayer will be able to obtain his deduction through the carry-back medium. Thus, taking his position against the present recognition of post-war reserves, Paul argued for provision for "seed money" by further refinement in the carry-back provisions.

Paul proposed a prompter refund of taxes to which firms are entitled—in that way the tax structure could make a substantial contribution in easing the transitional period. Additionally, Treasury has suggested to the Ways and Means Committee a special "Ruml" plan for corporations. This plan would let corporations file a tentative estimate of anticipated losses as soon as they see a bad year coming. Companies would file application for refund on a tentative basis along with their regular returns on the previous year's income; then they could offset the refund against taxes due and keep the difference to meet expenses.

At the present time Price Adjustment Boards are not legally bound to recognize reconversion reserves to any amount whatsoever as costs. If there is a change in the tax law to include certain of such reserves as tax deductions, then the Boards will be bound to accept them as cost items.

At the present time renegotiation officials defend their refusal on their own responsibility to treat reserves as cost items on four grounds:

1. Such special treatment for corporations with sufficient surplus to set up reserves would be grossly inequitable to other kinds of business.

2. Renegotiation and tax procedures have not impeded setting up of adequate corporation reserves.

3. Recognition of post-war reserves is highly impracticable from an administrative standpoint.

4. Congress has provided suitable means of carrying industry over the treacherous shoals of war-to-peace conversion.

On the ground of inequity, Price Adjustment Boards point out that this proposal for post-war reserves will help manufacturers whose facilities were suitable for war production and who were fortunate enough to make an excessive profit out of which extra funds could be segregated. It would be of no help, however, to businesses which were closed down because of shortages or who limped through the war because they were unable to get priorities. Moreover, members of the industry who charged high prices to the Government would be able to build up high reserves. On the other hand, those members who charged lower prices would in effect be penalized.

Publicly and privately, renegotiation officials have expressed their opinion that the plea for special Governmental action on post-war reserves is spurious—that industry possesses reserves even after taxes which may be adequate for the task ahead. Paul has given the following figures: Total corporate liabilities for income and excess profits taxes, amounting to slightly over $1¼ billion for 1937, have climbed to $13½ billion for the year 1943. But taxes, even of this magnitude, have not kept pace with rising earnings. Corporations in 1942 will have left after taxes $8.1 billion, and in 1943 more than $8.5 billion, sums more than double the $3.9 billion left after taxes for the year 1937, and equal or greater than the $8.1 billion of income after taxes in 1929. Moreover, the average of dividends paid for the years 1936 to 1940 was $4.1 billion, reaching the high figure of $4.8 in the year 1937. For the years 1941, 1942, and 1943, dividends are estimated at $4.5 billion, $4.1 billion, and $4.0 billion respectively. Even after taxes and dividends paid, corporations will have accumulated for the years 1942, 1943, and 1944 a total of nearly $14 billion of undistributed corporate profits.

It has been pointed out that the representatives of such giant corporations as General Electric and the Aluminum Company of America have stated in their testimony at Congressional hearings that their own existing reserves are ample to tide them through the period of reconversion. As an alternative to setting aside funds, companies are amply able, it is contended, to get access to private capital through floatation of stocks and bonds on the private market. Government officials point out, moreover, that the dilution of the present owner's equity is preferable to outright Government subsidy entailed through a recognition of post-war reserves.

Officials point out also that even under present renegotiation practice a company can help to ensure its own post-war future:

1. The cost of extensive research and engineering related to the war effort is an allowable expense both for tax purposes and renegotiation.

2. The maintenance of the executive staff and production personnel during the war as important to subsequent operations is fully recognized.

3. Institutional good will and industrial advertising will be treated as a proper charge against the contract if they are not out of proportion to the size of the company and its past advertising budget.

From an administrative standpoint, the renegotiation officers have objected to the inclusion of post-war reserves on several grounds. They advance the argument that the amount of reserves at the time when the burden will be incurred, the amount of the burden and the sector of industry upon which the most severe burden will fall cannot be foreseen. It would, moreover, be difficult to assure that these reserves would be readily available since without strings the contractor can distribute or invest the funds at his own discretion.

Again, if renegotiation recognized the reserves, but they were not allowed as tax deductions, it would be necessary for the Boards to allow four or five dollars of reserve for every dollar available to the company after taxes.

The final focus of attack for the opponents of the post-war reserve proposal is the action which has already been taken by Congress to facilitate post-war adjustment:

1. Section 250 of the Revenue Act of 1942 imposes what is tantamount to a compulsory accumulation of a post-war reserve; it provides for a post-war refund of 10% of the excess profits tax paid after December 31, 1941.

2. Accelerated depreciation permits a company to free from taxes and renegotiation its capital invested in plant and machinery.

3. Section 153 of the Revenue Act of 1942 permits a two-year carry-back or carry-forward of losses, thus mitigating the effect of losses. The corporation which does not use all its excess profits tax credit in any one year can carry back the unused part for two years, adding it to the credit it had in the reclaimed years and reducing the tax correspondingly. Similarly, a company that has a deficit in a year can refigure its taxes for the two preceding years, subtracting the deficit from the taxable income.

4. Congress has provided the three-year period after the war in which to replace inventory and secure a tax refund based upon the difference in replacement costs if higher than the current year in valuation. This in effect covers companies which switched to "lifo" and were thereby stuck when they liquidated peacetime inventories.

Senator Hatch has urged a different method of attack on the problem which has the support of Senator George. He urged as the most practical method of handling this problem a recent proposal to amend the tax law to provide that re-

serves claimed by taxpayers in amounts not exceeding 20% of taxable income be deductible as an operating expense in computing income and excess profits taxes, provided: (1) That the amount set aside in such reserves be invested in public issue of non-negotiable, non-interest-bearing Government bonds redeemable at any time prior to a date eighteen months after the cessation of hostilities; and (2) that simultaneously upon the liquidation of such securities the taxpayers must return the amount derived from such liquidation to his taxable income for the year of liquidation.

This scheme might appeal to the Administration because all current income would be taxed at some time, either this year or when securities are liquidated. Furthermore, the plan would be easy to administer, and at the same time has an appeal to business. The probability that the Excess Profits Tax will be repealed shortly after the war means that the 20% set aside now would be hit by lower taxes when cashed in later.

Miscellaneous Substantive Changes

Both the Senate and the House bills provide that all items allowable as deductions and exclusions under Chapters 1 and 2E of the Internal Revenue Code (excluding taxes measured by income) shall to the extent allowable to such contracts and subcontracts be allowed as items of cost. At the present time Price Adjustment Boards are bound to recognize items of the same character as those recognized for tax purposes, but can use their own judgment as to how much shall be admissible as costs. Thus Price Adjustment Boards in recognizing income tax deductions have allowed less, particularly as regards executive salaries, than would be allowed by the tax authorities. This provision, it would seem, would compel recognition of the same amounts. The same rule would apply to amortization. At present, normal depreciation only is recognized as cost. The difference between that amount and the 20% amortization under a certificate of necessity is to be set aside as non-renegotiable profit which will not be considered in determining excessive profit. The post-war commercial value of such facilities is considered in paring down renegotiable profit. This provision which makes cost treatment identical might have a hampering effect on renegotiation operations since it might compel re-opening of the renegotiation agreement two or three years afterwards when the books of a contractor are audited finally for tax purposes.

The bill both in House and Senate provides for a fair cost allowance at the exemption line in the case of integrated companies and that this exemption be made retroactive. The bill provides as follows: "In the case of a contractor or subcontractor who produces or acquires the product of a mine, oil, or gas well, or other mineral or natural deposit, or timber, and processes, refines, or treats such a product to and beyond the first form or state suitable for industrial use, or who produces or acquires an agricultural product and processes, refines, or treats such a product to and beyond the first form or state in which it is customarily sold or

in which it has an established market, the Board shall prescribe such regulations as may be necessary to give such contractor or subcontractor a cost allowance substantially equivalent to the amount which would have been realized by such contractor or subcontractor if he had sold such product at such first form or state."

PROCEDURAL AND ADMINISTRATIVE CHANGES

Establishment of Joint Price Adjustment Board

The House bill set up a War Department Price Adjustment Board consisting of five members, representatives of the War Department, Navy Department, Treasury, Maritime Commission, and Reconstruction Finance Corporation. The Finance Committee bill added a representative of the War Production Board, thereby making it a six-member board. A Joint Price Adjustment Board has already existed, but under this provision it would for the first time be given statutory life.

The bills give the contractor an absolute right to require review by the newly created Board and the Act provides that the Board may not delegate "the power, function, and duty to review orders determining excessive profits." The Joint Price Adjustment Board has expressed its reluctance to accept the new responsibility thrust upon it. The function of the Board hitherto has been to set up uniform purposes, principles, policies and interpretations. The requirement of review would now mean that the Board would have to set up a substantial administrative staff and carry on duties interfering with its regular responsibilities.

Right of Judicial Review

Any contractor or subcontractor aggrieved by an order of a Price Adjustment Board may within 90 days file a petition for a court review. According to the House bill, the court of review would be the Tax Court of the United States; according to the Senate bill, the Court of Claims. In view of the jammed calendar of the Tax Court, the overwhelming probability is that the House will accept the Senate suggestion. The court will have exclusive jurisdiction to determine the amount of excessive profits, if any, and this determination will not be reviewed or redetermined by any other court or agency. This court proceeding to finally determine excessive profits will not be treated as a proceeding to review the determination of the Board, but as a proceeding de novo.

This latter provision departs from the traditional procedure adopted in connection with administrative review. The court of review will start from scratch and all persons would have a right of recourse. The right of review and the scope would not be confined to the question as to whether the determination by the Board was the result of a mistake of law, fraud, arbitrary or capricious action, or was so grossly erroneous as to imply bad faith.

The most objectionable feature of the review is its retroactivity to blanket all prior determinations made under the Renegotiation Act, including voluntary agreements. This renders subject to court review thousands of voluntary bilateral agreements and renegotiation settlements totaling $5,000,000,000. The Court of

Claims will be swamped with litigations as few firms will be able to resist the pressure to review past agreements. As Under Secretary of the Navy Forrestal said: "Retroactive reopening of these agreements would put the contractors who have entered into them in an uncertain and perhaps embarrassing position. Officers and directors of the companies have made settlements on account of excessive profits which they consider to be in the best interests of their corporations. If these agreements are now to be thrown open to review, the board of directors of each of these companies would be faced with the problem of appealing, so as to discharge its duty to its stockholders, even though it believed that the renegotiation settlement was entirely fair and just. This provision is a mandate for mutually undesirable litigation."

Statement to Contractor

The new bill provides that whenever the Board makes a determination with respect to the amount of excessive profits, whether by an order or by voluntary agreement, it must at the request of the contractor prepare and furnish him with a statement of the determination, the facts used as a basis therefor, and all its reasons for the determination. This statement cannot be used in the Tax Court or the Court of Claims in connection with the redetermination of excessive profits. The Boards look with distaste on this requirement since it will be necessary to set out in writing to the contractor a statement of the facts and factors, unfavorable and favorable, of his efficiency, ability, contribution to the war effort, risk and other elements necessary in the determination of excessive profits. This material cannot be flattering in all cases. The criteria may be understood in informal discussion and yet may produce great dispute and dissent when set down in writing. It will certainly impair the informal atmosphere in which renegotiation proceedings are at present conducted.

Statute of Limitations Provisions

Under the House bill, no proceeding to determine the amount of excessive profits can be commenced by the Board more than one year after the close of the fiscal year in which the excessive profits were received or accrued; or one year after financial statements are filed by the contractor or subcontractor, whichever is the later; otherwise liabilities for the excessive profits for the fiscal year will be discharged. Under the Senate Finance bill, however, the end period for determining excessive profits is one year after the close of the fiscal year in which the excessive profits were received. In order to expedite the disposition of the case after a proceeding has been commenced, the bills provide that the liabilities for excessive profits with respect to which such proceeding was commenced will be discharged if a determination by agreement or order is not made within one year following the commencement of the renegotiation proceedings. This limitation does not apply to a review by the Board of an order by the Secretary. The one-year period of limitation may also be extended by agreement between the parties.

INDEX—WAR CONTRACT RENEGOTIATION